Bank of Scotland plc

Report and Accounts
2020

Member of Lloyds Banking Group

Contents

Registered office: The Mound, Edinburgh EH1 1YZ. Registered in Scotland No. 327000

Strategic report

Principal activities

Bank of Scotland plc (the Bank) and its subsidiaries (together, the Group) provide a wide range of banking and financial services.

The Group's revenue is earned through interest and fees on a broad range of financial services products including current and savings accounts, personal loans, credit cards and mortgages within the retail market; loans and other products to commercial, corporate and asset finance customers; and private banking.

Business review

In the year to 31 December 2020, the Group recorded a profit before tax of £883 million compared to £1,278 million in the year to 31 December 2019.

Total income decreased by £886 million, or 15 per cent, to £5,147 million in the year ended 31 December 2020 compared to £6,033 million in 2019 with a £220 million decrease in net interest income combined with a reduction of £666 million in other income.

Net interest income was £5,208 million in the year ended 31 December 2020, a decrease of £220 million, or 4 per cent compared to £5,428 million in 2019 reflecting the lower rate environment, actions taken during the year to support customers and reduced levels of customer activity and demand during the coronavirus pandemic.

Other income was £666 million lower at a net loss of £61 million in the year ended 31 December 2020 compared to a net gain of £605 million in 2019. Net fee and commission income was £121 million lower at £199 million in the year ended 31 December 2020 compared to £320 million in 2019, reflecting lower levels of customer activity, largely due to the coronavirus pandemic. Net trading income was £614 million lower at a net loss of £369 million in the year ended 31 December 2020 due to losses incurred on hedging arrangements entered into with fellow Lloyds Banking Group undertakings. Other operating income was £69 million higher at £109 million in the year ended 31 December 2020 compared to a net gain of £40 million in 2019.

Total operating expenses of £2,642 million were 39 per cent lower than in 2019, driven by significantly lower regulatory provisions and continued reductions in other operating expenses. Regulatory provisions benefitted from a £1,040 million reduction in charges in respect of payment protection insurance compared to 2019. Other operating expenses were down £553 million, driven by lower staff costs and ongoing cost management.

Impairment losses increased by £1,172 million to £1,622 million in the year ended 31 December 2020 compared with £450 million in 2019, largely reflecting potential future losses in light of the Group's revised economic outlook for the UK as a consequence of the coronavirus pandemic.

The tax credit for the year ended 31 December 2020 was £30 million representing an effective negative tax rate of 3 per cent compared to a tax expense of £604 million in 2019 representing an effective tax rate of 47 per cent. This is primarily as a result of a credit of £182 million on remeasurement of the Group's deferred tax balances following the UK government's decision to maintain the corporation tax rate at 19 per cent, which was substantively enacted on 17 March 2020.

Total assets were £65,446 million lower at £310,328 million at 31 December 2020 compared to £375,774 million at 31 December 2019. Loans and advances to customers increased in the year by £5,451 million to £263,766 million, compared to £258,315 million at 31 December 2019, driven by open mortgage book growth reflecting the strength of the UK housing market.

Amounts due from fellow Lloyds Banking Group undertakings were £68,546 million lower at £28,988 million compared to £97,534 million at 31 December 2019 as a result of increased levels of settlement activity during 2020.

Customer deposits were £11,156 million higher at £163,001 million at 31 December 2020 compared to £151,845 million at 31 December 2019 as a result of lower levels of customer spending during the pandemic and inflows to the Group's trusted brands.

Amounts due to fellow Lloyds Banking Group undertakings were £69,665 million lower at £91,953 million at 31 December 2020 compared to £161,618 million at the previous year end, as a result of increased levels of settlement activity during 2020.

Total equity increased by £298 million from £13,090 million at 31 December 2019 to £13,388 million at 31 December 2020 with total comprehensive income of £929 million and the issue of £1,000 million of other equity instruments more than offsetting £1,500 million of redemptions and £164 million of distributions on other equity instruments.

The Bank's common equity tier 1 capital ratio increased to 15.5 per cent (31 December 2019: 13.5 per cent), largely reflecting profits for the year, with the impact of the impairment charge partially mitigated through the increase in IFRS 9 transitional relief for capital. The tier 1 capital ratio increased to 19.1 per cent (31 December 2019: 18.2 per cent) following the increase in common equity tier 1 capital, partially offset by a net reduction in AT1 instruments following a redemption and the subsequent issuance of a new instrument. The total capital ratio increased to 22.1 per cent (31 December 2019: 22.0 per cent) reflecting the increase in tier 1 capital, largely offset by a reduction in tier 2 capital which reflected movements in the regulatory value of tier 2 instruments, partially offset by the issuance of a new tier 2 instrument and a net increase in eligible provisions and other adjustments.

Risk-weighted assets reduced by £29 million to £61,304 million at 31 December 2020 compared to £61,333 million at 31 December 2019, with reductions in operational and market risk-weighted assets broadly offset by an increase in credit risk-weighted assets driven by open mortgage book growth, credit migrations and retail model calibrations and updates.

Post-tax return on average assets was stable at 0.2 per cent.

Future developments

Information about future developments is provided with the Principal risks and uncertainties section below.

Capital position at 31 December 2020

Following a change in approach, the capital position of Bank of Scotland plc is now restated on the basis of the Bank where previously this was presented on the basis of the Group. Prior period comparatives reflect the position of the Bank at 31 December 2019. The Bank's capital position as at 31 December 2020, applying transitional rules in respect of legacy capital securities subject to current grandfathering provisions and IFRS 9 transitional arrangements, is set out in the following section.

Bank capital ratios (audited)

Capital resources (transitional)	At 31 December 2020 £m	At 31 December 2019 £m
Common equity tier 1		
Shareholders' equity per balance sheet	**10,770**	9.972
Cash flow hedging reserve	**45**	41
Other adjustments	**771**	246
	11,586	10,259
Less: deductions from common equity tier 1		
Goodwill and other intangible assets	**(470)**	(461)
Prudent valuation adjustment	**(79)**	(92)
Removal of defined benefit pension surplus	**(50)**	(37)
Deferred tax assets	**(1,477)**	(1,362)
Common equity tier 1 capital	**9,510**	8,307
Additional tier 1		
Additional tier 1 instruments	**2,221**	2,872
Total tier 1 capital	**11,731**	11,179
Tier 2		
Tier 2 instruments	**1,943**	2,572
Eligible provisions and other adjustments	**(97)**	(232)
Total tier 2 capital	**1,846**	2,340
Total capital resources	**13,577**	13,519
Risk-weighted assets (unaudited)	**61,304**	61,333
Common equity tier 1 capital ratio[1]	**15.5%**	13.5%
Tier 1 capital ratio[1]	**19.1%**	18.2%
Total capital ratio[1]	**22.1%**	22.0%

1 Reflecting the full impact of IFRS 9 at 31 December 2020, without the application of transitional arrangements, the Bank's common equity tier 1 capital ratio would be 14.2 per cent, the tier 1 capital ratio would be 17.8 per cent and the total capital ratio would be 21.4 per cent.

Table 1.2: Risk-weighted assets (unaudited)

	At 31 December 2020 £m	At 31 December 2019 £m
Risk-weighted assets (Bank)		
Foundation Internal Ratings Based (IRB) Approach	**4,245**	4,500
Retail IRB Approach	**39,137**	36,696
Other IRB Approach	**1,958**	1,778
IRB Approach	**45,340**	42,974
Standardised Approach	**5,815**	7,278
Credit risk	**51,155**	50,252
Counterparty credit risk	**473**	481
Credit valuation adjustment risk	**100**	78
Operational risk	**8,801**	9,357
Market risk	**220**	492
Underlying risk-weighted assets	**60,749**	60,660
Threshold risk-weighted assets	**555**	673
Total risk-weighted assets	**61,304**	61,333

Section 172(1) Statement

In accordance with the Companies Act 2006 (the 'Act'), the Directors provide this statement describing how they have had regard to the matters set out in section 172(1) of the Act, when performing their duty to promote the success of the Bank, under section 172. This statement also provides details of how the Directors have engaged with and had regard to the interests of key stakeholders.

The Directors of Lloyds Banking Group plc are also the Directors of the Bank. The Bank is a subsidiary of Lloyds Banking Group plc, and as such follows many of the processes and practices of this company, which are further referenced in this statement where relevant.

Engagement with all stakeholders

The Board is responsible for the long-term success of the Bank, setting and overseeing culture, purpose, values and strategy. The Board's understanding of stakeholders' interests is central to these responsibilities, crucial to the Bank's success, and informs key aspects of Board decision-making as set out in this statement.

Stakeholder engagement is embedded in all aspects of the Board's decision-making, it is also embedded in the Board's delegation of the management of the business to the Executive. The Executive, including the Group Chief Executive and Chief Financial Officer, provide the Board with details of material stakeholder interaction and feedback, through regular business updates. Stakeholder interests are also identified by the Executive in the wider proposals put to the Board. This year interaction with stakeholders was adapted to comply with the Government's measures in relation to COVID-19, and has been undertaken virtually as necessary.

Customers

COVID-19 response

The response to the COVID-19 pandemic has been a central focus for the Board since the start of the outbreak. Regular Board updates identified key areas of customer concern. In addition, the Group Chief Executive attended virtual customer engagement events, which provided an important opportunity for customers to raise directly any concerns on the matters of most significance to them. Areas of worry included customers' ability to meet their ongoing financial commitments, and to continue to operate their businesses as the extent of the economic impacts emerged.

The Board considered and approved the Bank's vital role in the Government's COVID-19 related business loan schemes, which provided funding to a range of client businesses across a number of economic sectors. Customer payment holidays were also introduced, complementing other means of support, including removing fees for missed payments and access to fixed term accounts without charge.

The Board supported further key actions, including the launch of two initiatives with digital inclusion training provider, We Are Digital. These included providing tablet devices free of charge to over-70s isolated by COVID-19, and a dedicated phone line giving vulnerable customers support in staying connected with digital activities, including managing online banking.

The essential nature of a deep understanding of challenges faced by customers in financial difficulty was also highlighted by the pandemic. The Board was updated regularly on the needs of these customers, which resulted in the provision of additional support. This included increased capacity to serve customers who needed the help of a colleague, and delivering related self-serve functionality where preferred by customers.

Customer feedback

Customer feedback is always a priority for the Board. Regular updates are provided which give valuable insight into performance in delivering on customer-related objectives, and on improving customer outcomes. With Board oversight, new means of sharing customer views were developed for use over the coming year. These will provide greater insight not only on customer experience, but also on the progress being made to improve customer satisfaction in the areas of most importance. This will in turn help in ensuring the Board can continue to focus on the things that matter most to customers and our clients.

The Board recognises the importance of understanding performance in supporting customers, including performance relative to peers. Related updates covered a range of internal and external measures, including customer indices and market share updates. Such updates provided important insight, and enabled the Board to recommend suitable customer related actions.

Helping Britain Recover

The needs of customers once the pandemic abates has also been a focus for the Board. This has included providing direction for the development of Lloyds Banking Group's Helping Britain Recover ambitions, in which the Bank participates, building on Lloyds Banking Group's purpose of Helping Britain Prosper. These ambitions seek to address the changes in priorities for our stakeholders, including our customers, as the country emerges from the pandemic. The Board oversaw the development of these ambitions, which aim to make sure that purpose remains aligned to a changing society, fully integrating societal objectives with business objectives. Read more on the Board's role in this process on page 6.

Technology transformation

The Board has taken steps to make sure the Bank continues to build on its response to customer demand for technology. Digital transformation has therefore remained a key focus, including supporting the development of a Cloud strategy, and the ongoing roll-out of technological developments for customers, discussed further on page 7.

Shareholders

The Bank is a wholly owned subsidiary of Lloyds Banking Group. The Directors ensure that the strategy, priorities, processes and practices of the Bank are fully aligned where required to those of Lloyds Banking Group, ensuring that the interests of Lloyds Banking Group as the Bank's sole shareholder are duly acknowledged. Further information in respect of the relationship of Lloyds Banking Group with its shareholders is included within the Strategic Report within the Lloyds Banking Group Annual Report and Accounts for 2020, available on the Lloyds Banking Group website.

Communities and environment

Helping Britain Recover

The Board has given much focus to overseeing the development of Lloyds Banking Group's Helping Britain Recover ambitions, which includes the business of the Bank. This continues the strategy of Helping Britain Prosper, designed to play a part in the UK's recovery from the COVID-19 pandemic, and is discussed in more detail below. The views of stakeholders have informed the development of these ambitions, which aim to integrate fully Lloyds Banking Group's and the Bank's societal objectives with business objectives.

Environmental ambitions

During the year the Board approved an ambitious goal, working with customers, Government and the market to help reduce the carbon emissions which Lloyds Banking Group, including the Bank, finances by at least 50 per cent by 2030. With Lloyds Banking Group's 2030 carbon emission reduction goal for its own operations met, the Board also considered the development of new internal carbon, energy and travel targets. Consideration was also given to the development of several new green finance products, tools and services. The Board's consideration of environmental ambitions is discussed below.

Regional Ambassadors
The Board continues to value the support provided by Lloyds Banking Group's ten regional ambassadors, who between them help in establishing strong relationships with local politicians, councils and other community institutions across the UK, including those relevant to the Bank. The feedback of these ambassadors informs not only the Board's view of stakeholder priorities, but allows insight to be offered on the major economic and social debates the country faces.

Helping Britain Recover
The Board considered it vital that Lloyds Banking Group, including the Bank, play a key role in the country's plan to rebuild the economy. In September 2020 Lloyds Banking Group launched The Big Conversation: Helping Britain Recover. A three-month series of roundtable discussions were held across all nations and regions of the UK, which encouraged open debate of the challenges facing the country during the pandemic, and how the UK could emerge with an economy that is more resilient and more sustainable.

The Big Conversation brought together many of the Board's key stakeholders, including businesses, community members, policy makers and subject matter experts across the UK's nations and regions. Focus was given to discussing the support and policy interventions these stakeholders considered necessary for a strong recovery from the pandemic. A final report, published in December 2020, was shared with all participants as well as with key politicians and policy makers, and is available on Lloyds Banking Group's website. The Board was pleased The Big Conversation was in this way able to amplify its stakeholders' voices to those who can make a difference.

In addition, the Board agreed in June that it was important to build a long term framework which would help Lloyds Banking Group and the Bank more fully integrate business ambitions with societal objectives, acting wherever possible as a positive driver for change. After considering recommendations from the Executive, built around feedback from stakeholders, the Board concluded the plan would focus on five key areas of stakeholder priority. These included help rebuild households' financial health and wellbeing, support businesses to recover, adapt and grow, expand availability of affordable and quality homes, accelerate the transition to a low carbon economy, and build an inclusive society and organisation.

Regulators and Government
COVID-19 response
Extensive engagement was needed with regulators and Government in the initial response to the COVID-19 crisis. This helped ensure the Bank's response could both best support customers, but also remain in step with Government priorities for supporting the stability of the wider UK economy. Senior leaders worked closely with the FCA, PRA and representatives of HM Treasury to agree participation in the COVID-19 related support schemes, keeping the Board apprised of all developments. Following these interactions, the Board approved participation in the Government's economic response, successfully providing customers with access to the Government's support measures and loan schemes. The Board continued to review the provision of this support as the year progressed, remaining close to the developing priorities of Government and regulators, as well as the impact on customers and business.

Regulatory agenda
The Chair and individual Directors have in the ordinary course of business had continuing discussions with the FCA and PRA on a number of aspects of the regulatory agenda. The Board in turn reviewed regular updates on wider regulatory interaction. This provided a view of key areas of regulatory focus, alongside progress being made in addressing regulatory priorities. Key areas of regulatory interest for the Board have included ensuring robust prudential standards, the fair treatment of customers, and the ongoing response to market changes. During the year such changes have included not only the response to COVID-19, but the UK's exit from the EU, in addition to climate change responsibilities, and ensuring ongoing financial and operational resilience.

Board members proactively engage with the regulators across all these areas, in addition to a standing programme of monthly updates. The Board continues to closely monitor the status of the Bank's regulatory relationship, seeking to enhance engagement particularly in key areas of regulatory change. During the coming year this is expected to include the ongoing impacts of COVID-19, including customer relief, in addition to EU exit transition, climate risk management and remuneration policy.

Environmental Ambitions
As a signal of the Group's commitment to sustainability, the Board approved an ambitious goal to reduce by 2030 the emissions Lloyds Banking Group, including the Bank, finances, on the path to net zero by 2050 or sooner.

Achieving these goals will not be easy, and the Board recognises the need to take a number of actions. These will over the coming years include investing in Group buildings, removing the use of natural gas from the estate, and progressing plans for zero carbon branches in communities across the UK. Many of the technologies needed are still new. The Board therefore recognises that close work will be needed with partners and suppliers in developing innovative new solutions.

Some initiatives were however approved for 2020, including the launch of a number of green finance products, tools and services. These included the Green Buildings Tool, a free to use insight tool launched specifically for Commercial Banking clients. The tool helps clients identify energy efficiency improvements relating to both commercial and residential buildings, along with the associated costs and benefits of those improvements. The tool complements the existing Green Lending Initiative in the real estate and housing sectors, and Clean Growth Finance Initiatives across all commercial sectors.

The year also saw the launch of the Green Living and Eco Home Hub for Halifax customers. This online tool is first in the market amongst lenders, providing mortgage customers with a tailored action plan on home improvements which can help improve sustainability. The Board will continue to oversee initiatives to help achieve sustainability goals, which will form a core part of strategy in the coming years.

Suppliers
Supplier experience
Recognising the role of suppliers in the Bank's day-to-day operations, and its future ambitions, the Board was keen that supplier experience be continually reviewed in order that it may be improved wherever it was possible to do so. As such the Board regularly considered supplier feedback, ensuring areas of potential improvement were acted upon.

Supplier framework
A Board-approved framework ensures the most significant supplier contracts receive the approval of the Board. The framework also ensures appropriate Executive oversight of supplier spending not considered by the Board, allowing challenge to be made where appropriate, and minimising risks and unnecessary cost. The Board reviewed updates on material related actions.

Supplier payment
The Board recognises that late payment of suppliers can represent a significant financial impact for them. As such the Board seeks to ensure supplier payment practices continue to meet wider industry standards. To that end, the Board's Audit Committee considered reports from Sourcing and Finance teams on the efficiency of supplier payment practices, including those relating to key supplier relationships.

Supply chain resilience
The impacts of the COVID-19 crisis have been no less material within the Bank's supply chain, with the Board keen to ensure these important relationships were not unduly impacted. The Board has also been mindful of the effects of the EU Exit on the supply chain, as the UK approached the deadline of the related transition period.

Related updates were considered on the work of the Supply Chain Resilience programme. This along with the Supplier Framework provided valuable assurance on the most critical supplier relationships, including those located in the EU. In particular the Board considered the work of the Incident Management process, an important means of support to key suppliers in managing the impacts of COVID-19 on their relationships with the Bank. The Board recognised the challenge of preparations by suppliers for finalisation of the EU Exit, in particular when combined with the pressures of the COVID-19 crisis. This included regular related updates for suppliers using Lloyds Banking Group's website.

Modern Slavery
The Board continues to have a zero tolerance attitude towards modern slavery in the supply chain, receiving updates on progress made in the ongoing enhancements to supplier practices. These included measures which address the risk of human trafficking and modern slavery in the wider supply chain.

Digital Transformation
As part of how Lloyds Banking Group and the Bank can continue to Help Britain Recover, the Board agreed that digital investment played a key role, enabling the Bank to best adapt to and support stakeholders' developing priorities. The Board agreed that as preparations were made for the next phase of strategy, acceleration of approach to the public cloud was central in further digitising the business, enabling improvement in the experience of both customers and colleagues.

While some big steps in digital transformation have already been taken, the Board agreed that cloud technology was key to building on this progress. This will include continuing to simplify IT systems, and enhancing IT architecture. Combining future-proofed cloud technology with smart customer data and insight, the aim is to deliver an even better and more personalised experience, regardless of the channel a customer chooses to do business with us.

Progress overseen by the Board has included the mobilising of a new Cloud Centre of Excellence, an important step in harnessing the opportunities cloud technology presents. The Board held two deep dive sessions in June and October to review the cloud strategy in detail. This allowed debate and challenge of the risks and further development of plans. The Board also participated in an insights programme on cloud technology to augment their current knowledge and understanding.

The Board was pleased that, despite the challenges of the pandemic, progress was also made in delivering technological developments which have helped to further improve customer experience. These included industry leading capability for customers to view and cancel subscription services for items such as their monthly TV streaming and broadband service providers, paid for via their current account.

Principal risks and uncertainties
2020 has been a year of significant uncertainty, including the spread of COVID-19 and its impact on global and domestic economies and the UK's exit from the European Union.

COVID-19 has had a significant impact on all risk types in 2020. Understanding and managing its impacts dynamically has been a major area of focus. The Lloyds Banking Group has responded quickly to the challenges faced, putting in place risk mitigation strategies and refining its investment and strategic plans.

All of the Lloyds Banking Group's principal risks, which are outlined below, are reported regularly to the Lloyds Banking Group Board.

Key focus areas in 2020
Climate – New
The Lloyds Banking Group recognises the evolving pace of Climate Risk and has adopted a comprehensive approach to embedding this risk within its enterprise risk management framework. This includes the creation of a new principal risk as well as its integration into existing principal risks. Work has also continued to develop scenario modelling and other analytical tools and to increase the level of external disclosure to further align to the Task Force on Climate-related Financial Disclosures (TCFD) recommendations.

Market
The Lloyds Bank Group's structural hedge, nominal balance £181 billion (2019: £173 billion), provides protection against margin compression caused by falling interest rates. In addition, customer deposits have seen significant growth in 2020 which creates near term interest rate exposure. Customer behaviour and hedging of these balances are reviewed regularly.

The Lloyds Banking Group's defined benefit pension schemes have seen an improvement in IAS19 accounting surplus to £1.6 billion (2019: £0.5 billion), as a result of Deficit Reduction Contributions and greater than expected asset returns partially offset by the impact of the Retail Price Index (RPI) reform announced by the Chancellor of the Exchequer in November 2020.

Credit
A range of measures have been deployed by Lloyds Banking Group to help support customers, including around 1.3 million payment holidays, c.£12 billion of additional government support scheme lending through the Bounce Back Loan (BBLS) and Coronavirus Business Interruption Loan (CBILS) schemes, together with liquidity facilities for larger clients.

This support together with the wide array of public policy interventions, such as the job retention scheme, has limited the increase in unemployment, and helped to suppress credit defaults and business failures.

The Lloyds Banking Group has responded dynamically to mitigate and address credit risk, with specific focus on higher risk segments, sectors and counterparties, as well as undertaking extensive preparation to support the expected increase in customers who may experience financial difficulty.

The 2020 full year impairment charge reflects the deteriorating economic outlook, with reserves built in anticipation of an increase in losses during 2021 as unemployment increases and more business failures are seen.

Funding and liquidity
The Lloyds Banking Group maintained its strong funding and liquidity position throughout 2020. Customer deposits increased significantly as spending reduced and customers deposited government lending scheme balances. During the year, the Lloyds Banking Group repaid all outstanding amounts of its Term Funding Scheme (TFS) and Funding for Lending Scheme (FLS) drawings and drew £13.7 billion from the Term Funding Scheme with additional incentives for SMEs (TFSME).

Capital
Lloyds Banking Group's underlying capital build was adversely impacted in 2020, mainly due to a significant uplift in impairment provisions, however the year-end capital position is significantly strengthened due to the earlier reversal of the 2019 full year ordinary dividend accrual and enhanced IFRS 9 transitional relief, which partially offset the increase in impairment provisions.

The Lloyds Banking Group's capital requirements have reduced in 2020 due to lower Pillar 2A requirements and the reduction in the UK countercyclical capital buffer rate in response to the impact of COVID-19. The Group therefore has significant headroom to absorb further potential losses and to continue to support households and businesses as they recover from the COVID-19 pandemic.

Change/execution
The Change/execution risk profile has remained stable in the year. The Lloyds Banking Group's change portfolio was reprioritised at pace to support critical and COVID-19 related activities. Enhanced, targeted control monitoring was implemented to ensure safe delivery of change during the year.

Conduct
The Lloyds Banking Group has adapted quickly to the impacts of the pandemic, providing significant support to impacted customers. Comprehensive preparations have been undertaken to help identify and further support those customers in financial difficulty.

Data
The Lloyds Banking Group continues to improve its capabilities in the management of data risk, with an improvement seen in the regular half yearly capability assessment. Areas of improvement include delivery of a new data risk and control library, embedding data by design and ethics principles into the data science lifecycle, increasing capabilities and broader awareness.

Governance
Governance risk has remained stable, despite the need for accelerated decision-making and a significant increase in the amount of remote working, together with a number changes to Lloyds Banking Group GEC and Board members throughout the year. Ensuring appropriate and efficient governance remains a key priority.

People
2020 has seen increased colleague workloads and significant changes to ways of working, with up to 50,000 Lloyds Banking Group colleagues working from home. Improved colleague sentiment demonstrates that the extensive support measures deployed by the Lloyds Banking Group, with a continued focus on colleague wellbeing and resilience, are helping to mitigate these risks.

Operational resilience
Business continuity plans have proved resilient, with particular attention applied to heightened risks in the supply chain.

Operational
Despite anticipated heightened operational risks in cyber, fraud and technology, the volume of operational loss events has remained broadly consistent in 2020 compared to 2019.

Model
Model risk has increased due to the nature and uncertainty of the economic outlook. The effect of government led customer support initiatives have weakened established relationships between model inputs and outputs, reducing the ability to forecast using models alone. While underlying model drivers are expected to remain valid in the longer term, year-end impairment reporting contains a greater element of governed judgement to reflect current conditions.

Regulatory and legal
Regulatory risk has been impacted by a small number of instances of non-compliance, requiring forbearance from regulators. Forbearance requirements have been due to the re-prioritisation of resource to support the provision of essential services to customers and to respond to new regulatory requirements, such as payment holidays. Legal risk has been impacted by the UK's exit from the EU, in particular continued uncertainty of the future UK legal and regulatory financial services framework.

Strategic
Strategic risk is a significant source of risk for the Lloyds Banking Group, influencing the Lloyds Banking Group's strategy, business model, performance and risk profile. The development of the strategic risk framework is a key priority for the Lloyds Banking Group.

Financial risk management objectives and policies
Information regarding the financial risk management objectives and policies of the Group, in relation to the use of financial instruments, is given in notes 39 and 42 to the accounts. The Group's approach to risk management including risk policies, risk appetite, measurement bases and sensitivities, in particular for credit risk, market risk and liquidity risk, is aligned to those of Lloyds Banking Group plc, the Bank's ultimate parent. Further information can be found in the Lloyds Banking Group plc Annual Report and Accounts.

The Group maintains risk management systems and internal controls relating to the financial reporting processes designed to:

- ensure that accounting policies are appropriately and consistently applied;
- enable the calculation, preparation and reporting of financial outcomes in line with applicable standards; and
- ensure that disclosures are made on a timely basis in accordance with statutory and regulatory requirements.

The 2020 Strategic Report has been approved by the Board of Directors.

On behalf of the Board

Robin Budenberg
Chair
Bank of Scotland plc
11 March 2021

Results
The consolidated income statement on page 25 shows a statutory profit before tax for the year ended 31 December 2020 of £883 million (year ended 31 December 2019: £1,278 million).

Dividends
During the year the Bank paid no interim dividends (2019: £500 million). The Directors have not recommended a final dividend for the year ended 31 December 2020 (2019: nil).

Post balance sheet events
There were no material post balance sheet events.

The anticipated impact on the Group's tax position of the UK Government's budget announcement on 3 March 2021 is discussed in note 27 to the accounts.

Going concern
The going concern of the Bank and the Group is dependent on successfully funding their respective balance sheets and maintaining adequate levels of capital. In order to satisfy themselves that the Bank and the Group have adequate resources to continue to operate for the foreseeable future, the directors have considered the Bank and the Group's principal risks and uncertainties, liquidity and projections for the Bank and the Group's capital and funding position. Taking all of these factors into account, the directors consider that it is appropriate to continue to adopt the going concern basis in preparing the financial statements. In reaching this assessment, the directors have considered the implications of the COVID-19 pandemic upon the Group's performance and projected funding and capital position and have also taken into account the impact of further stress scenarios. On this basis, the directors are satisfied that the Group will maintain adequate levels of funding and capital for the foreseeable future. Further details of the Group's funding and capital position are set out on pages 2 to 9.

Corporate Governance Statement
In accordance with the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (as amended by the Companies (Miscellaneous Reporting) Regulations 2018) (the 'Regulations'), for the year ended 31 December 2020, the Bank has in its corporate governance arrangements applied the Wates Corporate Governance Principles for Large Private Companies (the 'Principles'), which are available at frc.org.uk. The following section explains the Bank's approach to corporate governance, and its application of the Principles.

Fundamental to the Bank's strategy are high standards of corporate governance. A Corporate Governance Framework is in place for Lloyds Banking Group, the Bank, Lloyds Bank plc and HBOS plc, with all four companies sharing a common approach to governance. The framework is designed to meet the specific needs of each company, setting the wider approach and applicable standards in respect of the Bank's corporate governance practices, including addressing the matters set out in the Principles and the governance requirements of the operation of the Bank as part of Lloyds Banking Group's Ring Fenced Bank.

This includes the matters reserved to the Board, and the matters the Board has chosen to delegate to management, including decision making on operational matters such as those relating to credit, liquidity, and the day-to-day management of risk. Governance arrangements, including the Corporate Governance Framework, are reviewed at least annually to ensure they remain fit for purpose. The Board delegates further responsibilities to the Group Chief Executive, who is supported by the Group Executive Committee, the composition of which is detailed on pages 84 to 85 of the Lloyds Banking Group annual report and accounts for 2020. The Corporate Governance Framework of the Bank further addresses the requirements of the Principles as discussed on pages 11 to 12.

Board and Committee composition and attendance at meetings in 2020[13]

Board Member	Board	Nomination Committee	Audit Committee	Board Risk Committee	Remuneration Committee
Lord Blackwell	13/13[C]	7/7[C]	–	8/8	7/7
António Horta-Osório	13/13	–	–	–	–
William Chalmers	13/13	–	–	–	–
Juan Colombás[1]	10/10	–	–	–	–
Robin Budenberg[2]	3/3	1/1	–	2/2	2/2
Sarah Bentley	12/13[12]	–	–	7/8[12]	6/7[12]
Alan Dickinson[3]	13/13	7/7	7/7	8/8	7/7
Anita Frew[4]	6/7[10]	3/3	4/4	4/4	3/4[10]
Brendan Gilligan	13/13	–	7/7	8/8	–
Simon Henry[5]	11/11	–	6/6	5/6[12]	–
Nigel Hinshelwood	13/13	6/7[12]	6/7[12]	8/8	7/7
Sarah Legg[6]	13/13	–	7/7[C]	8/8	–
Lord Lupton	13/13	–	–	8/8	–
Amanda Mackenzie	13/13	–	–	8/8	7/7
Nick Prettejohn[7]	12/13[11]	5/6[11]	7/7	8/8[C]	–
Stuart Sinclair	12/13[10]	6/7[12]	–	8/8	7/7[C]
Sara Weller[8]	13/13	5/7[11,12]	–	7/8[12]	7/7
Catherine Woods[7,9]	11/11	–	1/1	6/6	5/5

C Chair
1 Juan Colombás retired from the Board on 18 September 2020.
2 Robin Budenberg joined the Board and respective Committees on 1 October 2020 and became Chair of the Nomination Committee on 1 January 2021.
3 Alan Dickinson succeeded Anita Frew as Deputy Chair on 21 May 2020.
4 Anita Frew retired from the Board on 21 May 2020.
5 Simon Henry retired from the Board on 30 September 2020.
6 Sarah Legg succeeded Simon Henry as Chair of the Audit Committee with effect from 1 October 2020.
7 Nick Prettejohn succeeded Alan Dickinson as Chair of the Board Risk Committee on 21 May 2020 and was succeeded in that role by Catherine Woods on 1 January 2021.
8 Sara Weller plans to retire as a Non-Executive Director at the AGM in May 2021.
9 Catherine Woods joined the Board and the Board Risk and Remuneration Committees on 1 March 2020 and the Audit Committee on 10 September 2020.
10 Unable to attend due to illness.
11 Unable to attend ad hoc meeting scheduled on a Sunday evening at short notice.
12 Unable to attend due to another business commitment.
13 Where a Director is unable to attend a meeting s/he receives papers in advance and has the opportunity to provide comments to the Chair of the Board or to the relevant Committee Chair.

Principle One – Purpose and Leadership
The Board is collectively responsible for the long term success of the Bank. It achieves this by agreeing the Bank's strategy, within the wider strategy of Lloyds Banking Group, and overseeing delivery against it. The Bank's strategy is discussed further in the Strategic Report on pages 2 to 9. The Board also assumes responsibility for the management of the culture, values and wider standards of the Bank, within the equivalent standards set by Lloyds Banking Group.

Consideration of the needs of all stakeholders is fundamental to the way the Bank operates, as is maintaining the highest standards of business conduct, which along with ensuring delivery for customers is a vital part of the corporate culture. The Bank's approach is further influenced by the need to build a culture in which everyone feels included, empowered and inspired to do the right thing for customers. To this end, the Board plays a lead role in establishing, promoting, and monitoring the Bank's corporate culture and values, with the Corporate Governance Framework ensuring such matters receive the level of prominence in Board and Executive decision making which they require. The Bank's corporate culture and values align to those of Lloyds Banking Group, which are discussed in more detail on page 45 of the Lloyds Banking Group annual report and accounts for 2020.

Principle Two – Board Composition
The Bank is led by a Board comprising a Non-Executive Chair, independent Non-Executive Directors and Executive Directors, further details of the Directors can be found on page 14. The Board considers its composition regularly and is committed to ensuring it has the right balance of skills and experience. The Board considers its current size and composition is appropriate to the Bank's circumstances. The Board places great emphasis on ensuring its membership reflects diversity in its broadest sense. New appointments are made on merit, taking account of the specific skills and experience, independence and knowledge needed to ensure a rounded board and the diversity benefits each candidate can bring overall. There are a range of initiatives across Lloyds Banking Group to help ensure unbiased career progression opportunities. Progress on diversity objectives is monitored by the Board and built into its assessment of executive performance.

The Board is supported by its committees, the operation of which are discussed below, which make recommendations to the Board on matters delegated to them, in particular in relation to internal control, risk, financial reporting and remuneration matters. Each committee has written terms of reference setting out its delegated responsibilities. Each committee comprises Non-Executive Directors with appropriate skills and experience and is chaired by an experienced chairman. The committee Chairs report to the Board at the next Board meeting. The Board undertakes an annual review of its effectiveness, which provides an opportunity to consider ways of identifying greater efficiencies, ways to maximise strengths and highlights areas of further development. The 2020 effectiveness review was commissioned by the Board, overseen by the Nomination Committee and conducted internally by the Company Secretary between November 2020 and January 2021. In addition to considering the effectiveness of the Board, the effectiveness of the Board committees and individual Directors was also considered, with individual performance evaluation conducted for each of the members of the Board.

Principle Three – Director Responsibilities
The Directors assume ultimate responsibility for all matters, and along with senior management are committed to maintaining a robust control framework as the foundation for the delivery of good governance, including the effective management of delegation through the Corporate Governance Framework. Policies are also in place in relation to potential conflicts of interest which may arise. All Directors have access to the services of the Company Secretary, and independent professional advice is available to the Directors at the expense of Lloyds Banking Group, where they judge it necessary to discharge their duties as directors.

The Board is supported by its committees which make recommendations on matters delegated to them under the Corporate Governance Framework. The management of all committees is in keeping with the basis on which meetings of the Board are managed, with open debate, and adequate time for members to consider proposals which are put forward. The Chair of the Board and each Board committee assumes responsibility with support from the Company Secretary for the provision to each meeting of accurate and timely information.

Principle Four – Opportunity and Risk
The Board oversees the development and implementation of the Bank's strategy, within the context of the wider strategy of Lloyds Banking Group, which includes consideration of all strategic opportunities. The Board is also responsible for the long term sustainable success of the Bank, generating value for its shareholders and ensuring a positive contribution to society. The Board agrees the Bank's culture, purpose, values and strategy, within that of Lloyds Banking Group, and agrees the related standards of the Bank, again within the relevant standards of Lloyds Banking Group. Further specific aims and objectives of the Board are formalised within the Corporate Governance Framework, which also sets out the matters reserved for the Board.

Strong risk management is central to the strategy of the Bank, which along with a robust risk control framework acts as the foundation for the delivery of effective management of risk. The Board agrees the Bank's risk appetite and ensures the Bank manages risk effectively, delegating related authorities to individuals through the Corporate Governance Framework and the further management hierarchy. Board level engagement coupled with the direct involvement of senior management in risk issues ensures that escalated issues are promptly addressed, and remediation plans are initiated where required. The Bank's risk appetite, principles, policies, procedures, controls and reporting are managed in conjunction with those of Lloyds Banking Group, and as such are regularly reviewed to ensure they remain fully in line with regulations, law, corporate governance and industry best practice. The Bank's principal risks are discussed further on pages 7 to 8.

Principle Five – Remuneration
The Remuneration Committee of the Board, in conjunction with the Remuneration Committee of Lloyds Banking Group (the 'Remuneration Committees'), assume responsibility for the Bank's approach to remuneration. This includes reviewing and making recommendations on remuneration policy as relevant to the Bank, ranging from the remuneration of Directors and members of the Executive to that of all other colleagues where the regulators require the Bank to implement a specific approach to their remuneration, such as Senior Managers and other material risk takers. The activities of the Remuneration Committees extend to matters of remuneration relevant to subsidiaries of the Bank, where such subsidiary does not have its own remuneration committee. Certain members of the Lloyds Banking Group Executive, including the Group People and Property Director, are authorised to act upon the decisions made by the Remuneration Committees, and to undertake such other duties relevant to remuneration as delegated to them.

Principle Six – Stakeholders
The COVID-19 pandemic has during the year had a profound effect on the way we live, including on the Bank's many stakeholders. The Board has monitored the impact of the pandemic on the Group's and Bank's business and its stakeholders, seeking to ensure that the challenges posed by the pandemic were addressed. The Board considered related updates from management as events unfolded, covering matters including the impact on customers, suppliers and other stakeholders, approving suitable action as required.

The Bank as part of Lloyds Banking Group operates under Lloyds Banking Group's wider Responsible Business approach, which acknowledges that the Bank has a responsibility to help address the economic, social and environmental challenges which the UK faces, and as part of this understand the needs of the Bank's external stakeholders, including in the development and implementation of strategy. Central to this is Lloyds Banking Group's Helping Britain Prosper plan, in which the Bank participates, which during the year has focused on the response to COVID-19, and Helping Britain Recover. This involved bringing together many of the Board's key stakeholders, to determine how the Bank could best support the recovery from the pandemic, the outcomes of this initiative being set out on pages 38 to 39 of the Lloyds Banking Group annual report and accounts for 2020.

Directors' report

In 2020 the Responsible Business Committee of Lloyds Banking Group provided further oversight and support of Lloyds Banking Group's and the Bank's strategy and plans for embedding responsible business in the Banks' core purpose. The Responsible Business Committee determined that the Bank and Lloyds Banking Group continued to demonstrate responsibility as a key priority. The approach of the Board in respect of its key stakeholders is described further in a separate statement made in compliance with the Regulations on pages 5 to 7.

Directors
The names of the current Directors are shown on page 14. Changes to the composition of the Board since 1 January 2020 up to the date of this report are shown in the table below.

	Joined the Board	Left the Board
Catherine Woods	1 March 2020	
Anita Frew		21 May 2020
Juan Colombás		18 September 2020
Simon Henry		30 September 2020
Robin Budenberg	1 October 2020	
Lord Blackwell		1 January 2021

As announced in December 2020, António Horta-Osório will step down as a Director of the Bank and as Group Chief Executive on 30 April 2021, to be succeeded by Charlie Nunn, who will as announced in November 2020 and February 2021, subject to regulatory approval join the Group in August 2021 as a Director of the Bank and as Group Chief Executive. As announced in January 2021, Sara Weller will retire at the forthcoming Lloyds Banking Group AGM.

Directors' indemnities
The Directors of the Bank, including the former Directors who retired during the year, have entered into individual deeds of indemnity with Lloyds Banking Group plc which constitute 'qualifying third party indemnity provisions' for the purposes of the Companies Act 2006. The deeds indemnify the Directors to the maximum extent permitted by law and remain in force. The deeds were in force during the whole of the financial year or from the date of appointment in respect of the Directors appointed in 2020. In addition, Lloyds Banking Group plc had appropriate Directors' and Officers' liability insurance cover in place throughout 2020. Deeds for existing Directors are available for inspection at the Bank's registered office.

Lloyds Banking Group plc has also granted deeds of indemnity by deed poll and by way of entering into individual deeds, which constitute 'qualifying third party indemnity provisions' to the Directors of the Group's subsidiary companies, including former Directors who retired during the year, and to colleagues subject to the provisions of the Senior Managers and Certification Regime. Such deeds were in force during the financial year ended 31 December 2020 and remain in force as at the date of this report. Qualifying pension scheme indemnities have also been granted to the Trustees of Lloyds Banking Group's Pension Schemes, including those schemes relevant to the Bank, which were in force for the whole of the financial year and remain in force as at the date of this report.

Information required under DTR 7.2
Certain information is incorporated into this report by reference. Information about internal control and risk management systems relating to the financial reporting process can be found on page 9.

Information about share capital is shown in note 30 on pages 73 to 74. The Bank is a wholly owned subsidiary of HBOS plc, which holds all of the Bank's issued ordinary share capital.

The Directors manage the business of the Bank under the powers set out in the Companies Act 2006 and the Bank's articles of association, these powers include those in relation to the issue or buy back of the Bank's shares.

The appointment and retirement of Directors is governed by the Bank's articles of association and the Companies Act 2006. The Bank's articles of association may only be amended by a special resolution of the shareholders in a general meeting.

Conflicts of interest
The Board has a comprehensive procedure for reviewing, and as permitted by the Companies Act 2006 and the Bank's articles of association, approving actual and potential conflicts of interest. Directors have a duty to notify the Chair and Company Secretary as soon as they become aware of actual or potential conflict situations. Changes to commitments of all Directors are reported to the Board and a register of potential conflicts and time commitments is regularly reviewed and authorised by the Board to ensure the authorisation status remains appropriate.

Lord Lupton is a senior advisor to Greenhill Europe, an investment bank focused on providing financial advice on significant mergers, acquisitions, restructurings, financings and capital raising to corporations, partnerships, institutions and governments. The Board has recognised that potential conflicts may arise as a result of this position. The Board has authorised the potential conflicts and requires Lord Lupton to recuse himself from discussions, should the need arise.

Branches, future developments and financial risk management objectives and policies
The Bank provides a wide range of banking and financial services through branches and offices in the UK and overseas. Information regarding future developments and financial risk management objectives and policies of the Group in relation to the use of financial instruments that would otherwise be required to be disclosed in the Directors' report, and which is incorporated into this report by reference, can be found in the Strategic Report.

Share capital
Information about share capital is shown in note 30 on pages 73 to 74. This information is incorporated into this report by reference. The Bank did not repurchase any of its shares during 2020 (2019: none). There are no restrictions on the transfer of shares in the Bank other than as set out in the articles of association and certain restrictions which may from time to time be imposed by law and regulations.

Change of control
The Bank is not party to any significant agreements which take effect, alter or terminate upon a change of control of the Bank following a takeover bid. There are no agreements between the Bank and its Directors or employees providing compensation for loss of office or employment that occurs because of a takeover bid.

Research and development activities
During the ordinary course of business, the Bank develops new products and services.

Directors' report

Information incorporated by reference
The following additional information forms part of the Directors' Report and is incorporated by reference.

Content		Pages
Disclosures required under the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008	Statement of stakeholder engagement	5 to 7

Significant contracts
Details of related party transactions are set out in note 36 on pages 79 to 81.

Statement of directors' responsibilities
The Directors are responsible for preparing the annual report and the financial statements in accordance with applicable law and regulations.

Company law requires the Directors to prepare financial statements for each financial year. Under that law, the Directors have prepared the Group and Bank financial statements in accordance with international accounting standards in conformity with the requirements of the Companies Act 2006. Additionally, the Financial Conduct Authority's Disclosure Guidance and Transparency Rules require the Directors to prepare the Group financial statements in accordance with international Financial Reporting Standards adopted pursuant to Regulation (EC) No 1606/2002 as it applies in the European Union.

Under company law, the Directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the Bank and the Group and of the profit or loss of the Group and the Bank for that period. In preparing these financial statements, the Directors are required to: select suitable accounting policies and then apply them consistently; make judgements and accounting estimates that are reasonable and prudent; and state whether for the Group and Bank, international accounting standards in conformity with the requirements of the Companies Act 2006 and, for the Group, international financial reporting standards adopted pursuant to Regulation (EC) No 1606/2002 as it applies in the European Union have been followed.

The Directors are responsible for keeping adequate accounting records that are sufficient to show and explain the Bank's transactions and disclose with reasonable accuracy at any time the financial position of the Group and the Bank and enable them to ensure that the financial statements comply with the Companies Act 2006 and, as regards the Group financial statements, International Financial Reporting Standards adopted pursuant to Regulation (EC) No 1606/2002 as it applies in the European Union. They are also responsible for safeguarding the assets of the Group and the Bank and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

A copy of the financial statements is placed on the website www.lloydsbankinggroup.com. The Directors are responsible for the maintenance and integrity in relation to the Bank on that website. Legislation in the UK governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

Each of the current Directors, who are in office as at the date of this report and whose names are shown on page 14 of this annual report, confirms that, to the best of his or her knowledge:

- the Group financial statements, which have been prepared in accordance with international accounting standards in conformity with the requirements of the Companies Act 2006 and in accordance with international financial reporting standards adopted pursuant to Regulation (EC) No 1606/2002 as it applies in the European Union and the Bank financial statements which have been prepared in accordance with international accounting standards in conformity with the requirements of the Companies Act 2006, give a true and fair view of the assets, liabilities and financial position and the profit or loss of the Group and the Bank; and
- the management report contained in the Strategic Report and the Directors' Report includes a fair review of the development and performance of the business and the position of the Group and Bank, together with a description of the principal risks and uncertainties that they face.

The Directors consider that the annual report and accounts, taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess the Bank's position and performance, business model and strategy. The Directors have also separately reviewed and approved the Strategic Report.

Independent auditor and audit information
Each person who is a Director at the date of approval of this report confirms that, so far as the Director is aware, there is no relevant audit information of which the Bank's auditor is unaware and each Director has taken all the steps that he or she ought to have taken as a Director to make himself or herself aware of any relevant audit information and to establish that the Bank's auditor is aware of that information. This confirmation is given and should be interpreted in accordance with the provisions of the Companies Act 2006. A resolution concerning the appointment of Deloitte LLP as auditor will be proposed at the Bank's 2021 annual general meeting.

On behalf of the Board

Kate Cheetham

Kate Cheetham
Company Secretary
11 March 2021

Bank of Scotland plc
Registered in Scotland
Company Number SC327000

Directors

Current Directors

Robin Budenberg CBE *Chair* (Non-Executive Director from 1 October 2020 and Chair from 1 January 2021)

António Horta-Osório *Executive Director and Group Chief Executive*

William Chalmers *Executive Director and Chief Financial Officer*

Sarah Bentley

Alan Dickinson

Brendan Gilligan

Nigel Hinshelwood

Sarah Legg

Lord Lupton CBE

Amanda Mackenzie OBE

Nick Prettejohn

Stuart Sinclair

Sara Weller CBE

Catherine Woods (from 1 March 2020)

Forward looking statements

This document contains certain forward looking statements within the meaning of Section 21E of the US Securities Exchange Act of 1934, as amended, and section 27A of the US Securities Act of 1933, as amended, with respect to the business, strategy, plans and/or results of Bank of Scotland plc together with its subsidiaries (the Group) and its current goals and expectations relating to its future financial condition and performance. Statements that are not historical facts, including statements about the Group's or its directors' and/or management's beliefs and expectations, are forward looking statements.

Words such as 'believes', 'achieves', 'anticipates', 'estimates', 'expects', 'targets', 'should', 'intends', 'aims', 'projects', 'plans', 'potential', 'will', 'would', 'could', 'considered', 'likely', 'may', 'seek', 'estimate' and variations of these words and similar future or conditional expressions are intended to identify forward looking statements but are not the exclusive means of identifying such statements.

Examples of such forward looking statements include, but are not limited to, statements or guidance relating to: projections or expectations of the Group's future financial position including profit attributable to shareholders, provisions, economic profit, dividends, capital structure, portfolios, net interest margin, capital ratios, liquidity, risk-weighted assets (RWAs), expenditures or any other financial items or ratios; litigation, regulatory and governmental investigations; the Group's future financial performance; the level and extent of future impairments and write-downs; statements of plans, objectives or goals of the Group or its management including in respect of statements about the future business and economic environments in the UK and elsewhere including, but not limited to, future trends in interest rates, foreign exchange rates, credit and equity market levels and demographic developments; statements about competition, regulation, disposals and consolidation or technological developments in the financial services industry; and statements of assumptions underlying such statements.

By their nature, forward looking statements involve risk and uncertainty because they relate to events and depend upon circumstances that will or may occur in the future.

Factors that could cause actual business, strategy, plans and/or results (including but not limited to the payment of dividends) to differ materially from forward looking statements made by the Group or on its behalf include, but are not limited to: general economic and business conditions in the UK and internationally; market related trends and developments; fluctuations in interest rates, inflation, exchange rates, stock markets and currencies; any impact of the transition from IBORs to alternative reference rates; the ability to access sufficient sources of capital, liquidity and funding when required; changes to the credit ratings of the Group or any of the Group's immediate or ultimate parent entities (if applicable); the ability to derive cost savings and other benefits including, but without limitation as a result of any acquisitions, disposals and other strategic transactions; the ability to achieve strategic objectives; the Group's ESG targets and/or commitments; changing customer behaviour including consumer spending, saving and borrowing habits; changes to borrower or counterparty credit quality impacting the recoverability and value of balance sheet assets; concentration of financial exposure; management and monitoring of conduct risk; exposure to counterparty risk (including but not limited to third parties conducting illegal activities without the Group's knowledge); instability in the global financial markets, including Eurozone instability, instability as a result of uncertainty surrounding the exit by the UK from the European Union (EU), the EU-UK Trade and Cooperation Agreement, and as a result of such exit and the potential for other countries to exit the EU or the Eurozone and the impact of any sovereign credit rating downgrade or other sovereign financial issues; political instability including as a result of any UK general election and any further possible referendum on Scottish independence; technological changes and risks to the security of IT and operational infrastructure, systems, data and information resulting from increased threat of cyber and other attacks; natural, pandemic (including but not limited to the COVID-19 pandemic) and other disasters, adverse weather and similar contingencies outside the control of the Group or any of the Group's immediate or ultimate parent entities (if applicable); inadequate or failed internal or external processes or systems; acts of war, other acts of hostility, terrorist acts and responses to those acts, or other such events; geopolitical unpredictability; risks relating to climate change; changes in laws, regulations, practices and accounting standards or taxation, including as a result of the UK's exit from the EU; changes to regulatory capital or liquidity requirements (including regulatory measures to restrict distributions to address potential capital and liquidity stress) and similar contingencies outside the control of the Group or any of the Group's immediate or ultimate parent entities (if applicable); the policies, decisions and actions of governmental or regulatory authorities or courts in the UK, the EU, the US or elsewhere including the implementation and interpretation of key laws, legislation and regulation together with any resulting impact on the future structure of the Group; the ability to attract and retain senior management and other employees and meet its diversity objectives; actions or omissions by the Group's directors, management or employees including industrial action; changes to the Group's post-retirement defined benefit scheme obligations; the extent of any future impairment charges or write-downs caused by, but not limited to, depressed asset valuations, market disruptions and illiquid markets; the value and effectiveness of any credit protection purchased by the Group; the inability to hedge certain risks economically; the adequacy of loss reserves; the actions of competitors, including non-bank financial services, lending companies and digital innovators and disruptive technologies; and exposure to regulatory or competition scrutiny, legal, regulatory or competition proceedings, investigations or complaints. Please refer to the latest Annual Report on Form 20-F filed by Lloyds Banking Group plc with the US Securities and Exchange Commission for a discussion of certain factors and risks.

Lloyds Banking Group may also make or disclose written and/or oral forward looking statements in reports filed with or furnished to the US Securities and Exchange Commission, Lloyds Banking Group annual reviews, half-year announcements, proxy statements, offering circulars, prospectuses, press releases and other written materials and in oral statements made by the directors, officers or employees of Lloyds Banking Group to third parties, including financial analysts.

Except as required by any applicable law or regulation, the forward looking statements contained in this document are made as of today's date, and the Group expressly disclaims any obligation or undertaking to release publicly any updates or revisions to any forward looking statements contained in this document to reflect any change in the Group's expectations with regard thereto or any change in events, conditions or circumstances on which any such statement is based. The information, statements and opinions contained in this document do not constitute a public offer under any applicable law or an offer to sell any securities or financial instruments or any advice or recommendation with respect to such securities or financial instruments.

INDEPENDENT AUDITORS' REPORT TO THE MEMBERS OF BANK OF SCOTLAND PLC

Report on the audit of the financial statements

Opinion

In our opinion, the financial statements of Bank of Scotland plc (the Group) and the Bank financial statements (together, the "financial statements"):

– give a true and fair view of the state of the Group's and of the Bank's affairs as at 31 December 2020 and of the Group's profit and the Group's and Bank's cash flows for the year then ended;
– have been properly prepared in accordance with international accounting standards in conformity with the requirements of the Companies Act 2006; and
– have been prepared in accordance with the requirements of the Companies Act 2006.

We have audited the financial statements, included within the Report and Accounts (the "Annual Report"), which comprise: the balance sheets as at 31 December 2020; the consolidated income statement and the statements of comprehensive income for the year then ended; the statements of changes in equity for the year then ended; the cash flow statements for the year then ended; and the notes to the financial statements, which include a description of the significant accounting policies.

Our opinion is consistent with our reporting to the Audit Committee.

Separate opinion in relation to international financial reporting standards adopted pursuant to Regulation (EC) No 1606/2002 as it applies in the European Union

As explained in note 1 to the Group financial statements, the Group, in addition to applying international accounting standards in conformity with the requirements of the Companies Act 2006, has also applied international financial reporting standards adopted pursuant to Regulation (EC) No 1606/2002 as it applies in the European Union.

In our opinion, the Group financial statements have been properly prepared in accordance with international financial reporting standards adopted pursuant to Regulation (EC) No 1606/2002 as it applies in the European Union.

Separate opinion in relation to IFRSs as issued by the IASB

As explained in note 1 to the financial statements, the Group, in addition to applying international accounting standards in conformity with the requirements of Companies Act 2006, has also applied international financial reporting standards (IFRSs) as issued by the International Accounting Standards Board (IASB).

In our opinion, the Group financial statements have been properly prepared in accordance with IFRSs as issued by the IASB.

Basis for opinion

We conducted our audit in accordance with International Standards on Auditing (UK) ("ISAs (UK)") and applicable law. Our responsibilities under ISAs (UK) are further described in the Auditors' responsibilities for the audit of the financial statements section of our report. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Independence

We remained independent of the Group in accordance with the ethical requirements that are relevant to our audit of the financial statements in the UK, which includes the FRC's Ethical Standard, as applicable to listed public interest entities, and we have fulfilled our other ethical responsibilities in accordance with these requirements.

To the best of our knowledge and belief, we declare that non-audit services prohibited by the FRC's Ethical Standard were not provided to the Group headed by Lloyds Banking Group plc, of which the Bank is a member.

Other than disclosed in note 10 to the financial statements, we have provided no non-audit services to the Group in the period under audit.

Our audit approach

Overview

Audit scope

– The scope of our audit and the nature, timing and extent of audit procedures performed were determined by our risk assessment, the financial significance of components and other qualitative factors (including history of misstatement through fraud or error).
– We performed audit procedures over components considered financially significant in the context of the Group (full scope audit) or in the context of individual primary statement account balances (audit of specific account balances). We performed other procedures including testing entity level controls, information technology general controls and analytical review procedures to address the risk of material misstatement in the residual components above performance materiality.

Key audit matters

– Allowance for Expected Credit Losses (ECL) (Group and Bank)
– Hedge accounting (Group and Bank)
– Privileged access to IT systems (Group and Bank)
– Impact of COVID-19 (Group and Bank)

Materiality

– Overall Group materiality: £120m (2019: £120m) based on 5 per cent of the four-year average adjusted profit before tax for the financial years ended 31 December 2017, 2018, 2019 and 2020, adjusted to remove the effects of certain items which were considered to have a disproportionate impact.
– Overall Bank materiality: £120m (2019: £120m) based on 1 per cent of total assets but limited to the overall Group materiality.
– Performance materiality: £90m (Group and Bank).

The scope of our audit

As part of designing our audit, we determined materiality and assessed the risks of material misstatement in the financial statements.

Capability of the audit in detecting irregularities, including fraud

Irregularities, including fraud, are instances of non-compliance with laws and regulations. We design procedures in line with our responsibilities, outlined in the Auditors' responsibilities for the audit of the financial statements section, to detect material misstatements in respect of irregularities, including fraud. The extent to which our procedures are capable of detecting irregularities, including fraud, is detailed below.

Independent auditors' report

Based on our understanding of the Group and industry, we identified that the principal risks of non-compliance with laws and regulations related to breaches of banking laws and regulations such as, but not limited to, regulations relating to consumer credit and unethical and prohibited business practices, and we considered the extent to which non-compliance might have a material effect on the financial statements. We also considered those laws and regulations that have a direct impact on the preparation of the financial statements such as the Companies Act 2006. We evaluated management's incentives and opportunities for fraudulent manipulation of the financial statements (including the risk of override of controls), and determined that the principal risks were related to posting manual journal entries to manipulate financial performance, management bias through judgements and assumptions in significant accounting estimates and significant one-off or unusual transactions. The Group engagement team shared this risk assessment with the component auditors so that they could include appropriate audit procedures in response to such risks in their work. Audit procedures performed by the Group engagement team and/or component auditors included:

– Discussions with management and those charged with governance including consideration of known or suspected instances of non-compliance with laws and regulations and fraud.
– Evaluation and testing of the operating effectiveness of management's entity level controls designed to prevent and detect irregularities, in particular their code of conduct and whistleblowing helpline.
– Assessment of matters reported on the Group's whistleblowing helpline and the results of management's investigation of such matters.
– Performing testing over period end adjustments.
– Incorporating unpredictability into the nature, timing and/or extent of our testing.
– Reviewing key correspondence with the FCA and PRA.
– Challenging assumptions and judgements made by management in their significant accounting estimates, in particular in relation to the allowance for ECL (see related key audit matters below).
– Identifying and testing journal entries, in particular any manual journal entries posted by unexpected or unusual users, posted with descriptions indicating a higher level of risk, and posted late with a favourable impact on financial performance.

There are inherent limitations in the audit procedures described above. We are less likely to become aware of instances of non-compliance with laws and regulations that are not closely related to events and transactions reflected in the financial statements. Also, the risk of not detecting a material misstatement due to fraud is higher than the risk of not detecting one resulting from error, as fraud may involve deliberate concealment by, for example, forgery or intentional misrepresentations, or through collusion.

Key audit matters

Key audit matters are those matters that, in the auditors' professional judgement, were of most significance in the audit of the financial statements of the current period and include the most significant assessed risks of material misstatement (whether or not due to fraud) identified by the auditors, including those which had the greatest effect on: the overall audit strategy; the allocation of resources in the audit; and directing the efforts of the engagement team. These matters, and any comments we make on the results of our procedures thereon, were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

This is not a complete list of all risks identified by our audit.

Payment Protection Insurance (PPI), which was a key audit matter last year, is no longer included because of the significant reduction in the amount and the level of estimation uncertainty of the PPI provision by 31 December 2020. This was a result of the Group processing almost all PPI information requests and complaints. Otherwise, the key audit matters below are consistent with last year.

Key audit matter	How our audit addressed the key audit matter
Allowance for Expected Credit Losses (ECL) (Group and Bank) *Refer to page 33 (Note 2: Accounting policies), page 39 (Note 3: Critical accounting judgements and estimates) and page 56 (Note 15: Financial assets at amortised cost).* The determination of the allowance for ECL is a judgemental area. A number of judgements and assumptions are outlined in the financial statements, including the definition of significant increases in credit risk, and the application of forward-looking information. *Group economics* The Group's economics team develops future economic scenarios. The base case economic scenario is determined through the application of judgement. There is a high level of estimation uncertainty in the base case due to the inherent complexity in forecasting future economic outcomes. The impact of COVID-19 on the economy has significantly increased the level of uncertainty in the base case forecasts. A central adjustment to the allowance of ECL of £200 million has been recognised primarily to reflect the level of uncertainty in the conditioning assumptions used to produce the base case. The outer scenarios are generated and selected through the use of a statistical model that is conditioned on the base case. The four economic scenarios represent distinct parts of the loss distribution which is developed based on historical experience. The scenarios, together with their weightings, are provided to the Retail and Commercial Banking divisions and act as key assumptions for the calculation of the allowance for ECL. *Retail* The allowance for ECL relating to loans and advances in the Retail division is determined on a collective basis, with the use of impairment models. These models use a number of key assumptions including probability of default, loss given default (including propensity for possession and forced sale discounts for mortgages) and valuation of recoveries. Management also apply judgemental adjustments where they believe the model calculated assumptions and allowances are not appropriate, either due to emerging trends or model limitations. An example of this are adjustments to the impairment model for anticipated increases in account defaults across the portfolio. There has been an increase in adjustments to the modelled ECL in the current year which reflects the fact that the historical data used in the development of the models does not capture conditions of the COVID-19 pandemic experienced during 2020. Our work therefore focused on the appropriateness of modelling methodologies adopted and significant judgements made in determining adjustments to the modelled ECL as well as the measurement of those adjustments. *Commercial Banking* The allowance for ECL relating to 'good book' or non-credit impaired loans and advances (referred to as being in Stages 1 and 2) in the Commercial Banking division is determined on a collective basis, with the use of impairment models. These models use a number of key assumptions including probability of default, loss given default and valuation of recoveries. Management also apply judgemental adjustments where they believe the model calculated assumptions and allowances are not appropriate, either due to emerging trends or model limitations. An example of this is adjustments to the impairment model for anticipated increases to account deterioration across the portfolio that have been deferred through the impact of government support schemes. There has been an increase in the use of judgemental adjustments to modelled ECLs in the current year which reflects the fact that the historical data used in the development of the models does not capture all the conditions of the COVID-19 pandemic experienced during 2020.	*Group economics* We understood management's process and tested key controls relating to the generation, selection and weighting of economic scenarios. We engaged our internal economic experts and risk modelling specialists to assist us as we evaluated: – The appropriateness of the base case economic scenario, focusing on the key UK economic assumptions (gross domestic product, UK Bank Rate, unemployment rate, house price growth and commercial real estate price growth); – The approach to the generation and selection of economic scenarios representing the upside, downside and severe downside; – The Group's internally developed statistical model, including changes implemented during the year and the Group's model validation process; and – The review, challenge and approval of the economic scenarios within the Group's governance processes. We found the key controls were designed, implemented and operated effectively, and therefore determined that we could place reliance on these key controls for the purposes of our audit. Where control deficiencies were identified, management identified compensating controls which we tested and were able to place reliance on. We critically assessed the key assumptions adopted in the base case economic scenario by comparing them to our independent view of the economic outlook and market consensus data. We investigated key economic variables outside of our thresholds. We also assessed the risk of bias in the forecasts, as well as the existence of contrary evidence. We independently re-performed the Group's model and performed testing to evaluate the level of non-linearity captured in the allowance for ECL. We also assessed the appropriateness of the weightings adopted. With respect to the central adjustment of £200m, we evaluated whether the use of a central adjustment was appropriate, the method for measuring the adjustment, the assumptions used in developing the estimate, and assessed the appropriateness of disclosures. Based on the evidence assessed, we found the assumptions to be materially appropriate, and the economic scenarios adopted to reflect an unbiased, probability weighted view, that appropriately captures the impact of non-linearity. We considered that the use of a central adjustment was an appropriate approach. *Retail* We understood management's process and evaluated and tested key controls relating to the determination of the allowance for ECL, including controls relating to: – Appropriateness of modelling methodologies and monitoring of model performance; – Model review and approval; – The identification of credit impairment events; and – The review, challenge and approval of the allowances for ECL, including the impairment model outputs, key management judgements and adjustments to modelled ECL applied. We found key controls that were designed, implemented and operating effectively, and therefore determined that we could place reliance on these key controls for the purposes of our audit. Where control deficiencies were identified, management identified compensating controls which we tested and were able to place reliance on.

Our work therefore focused on the appropriateness of modelling methodologies adopted and significant judgements made in determining adjustments as well as the measurement of those adjustments.

The allowance for ECL relating to credit impaired loans and advances (referred to herein also as being in Stage 3) in the Commercial Banking division is primarily estimated on an individual basis. Judgement is required to determine when a loan is considered to be credit impaired, and then to estimate the expected future cash flows related to that loan under multiple weighted scenario outcomes.

We understood and assessed the appropriateness of the impairment models developed and used by management. This included assessing and challenging the appropriateness of key modelling judgements (e.g. criteria used to determine significant increase in credit risk) and quantifying the impact of the use of proxies and simplifications, assessing whether these were appropriate. For selected portfolios, we created our own independent models covering certain parts of the model calculation which enabled us to re-perform management's calculation and challenge their outputs.

We performed testing over the measurement of the judgemental adjustments to modelled ECLs in place, focusing on the larger adjustments and those which we considered to represent the greatest level of audit risk (e.g. judgements relating to calibration adjustments in respect of payment performance experience in 2020, to past term interest-only exposures and adjustments made to assumptions relating to the probability of accounts defaulting). We assessed the appropriateness of methodologies used to determine and quantify the adjustments required and the reasonableness of key assumptions. Based on our knowledge and understanding of the weaknesses and limitations in management's models and industry emerging risks, we critically assessed the completeness of the judgemental adjustments proposed by management.

We used credit risk modelling specialists to support the audit team in the performance of these audit procedures.

Based on the evidence assessed, we found the methodologies, modelled assumptions and data used within the allowance for ECL assessment to be materially appropriate and in line with the requirements of IFRS 9.

Commercial Banking
We understood management's process and evaluated and tested key controls around the determination of the allowance for ECL. For the Stage 1 and 2 allowance, we focused on:

- The identification and assessment of the completeness and accuracy of critical data applied in the ECL calculation;
- The accuracy and timeliness of updates to credit risk ratings, which are applied in assessing whether loans have suffered a significant increase in credit risk since initial recognition;
- The governance over the ECL determination, including the validation of the ECL methodology, assumptions and inputs, and the annual model performance validation, and;
- The review, challenge and approval processes in place to assess the overall reasonableness of the allowance for ECL, alongside other available credit risk related information within the Group.

For the Stage 3 allowance, we focused on:

- The controls in place for the identification of credit impaired loans and subsequent transfer of these cases to the credit loss assessment team; and
- The review, challenge and approval processes that are in place to assess the overall reasonableness of the allowance for ECL.

We found these key controls were designed, implemented and operated effectively, and therefore determined that we could place reliance on these key controls for the purposes of our audit. Where control deficiencies were identified, management identified compensating controls which we tested and were able to place reliance on.

We performed the following procedures over the Stage 1 and 2 allowance for ECL:

- We critically assessed whether the methodology applied in the calculation is compliant with IFRS 9;
- We tested the formulae applied within the calculation, including the appropriateness, and application of, the quantitative and qualitative criteria used to assess significant increases in credit risk;
- We evaluated the accuracy and timing of the information being used to calculate a borrower's internal credit risk rating;
- We assessed whether the most recent internal credit risk rating assessment was performed sufficiently timely to incorporate the recent economic environment;

- We critically assessed the impact of identified model limitations and the justification for judgemental adjustments applied by management.

We performed the following procedures to test the completeness of credit impaired assets requiring a Stage 3 allowance for ECL:

- We critically assessed the criteria for determining whether a credit impairment event had occurred; and
- We tested a risk based sample of Stage 1 and 2 loans, utilising industry specialists to support the audit team in identifying sectors or types of borrowers with a heightened risk of weaker financial performance or distress.

For each risk based sample, as well as an additional haphazardly selected sample of Stage 1 and 2 loans, we independently assessed whether there was evidence indicating a credit impairment event (e.g. a customer experiencing significant financial difficulty or in breach of covenant) and therefore whether they were appropriately categorised. Our testing included consideration of events subsequent to the balance sheet date.

Additionally, we selected a sample of borrowers from management's 'watchlist', identified as requiring close credit risk monitoring, but not assessed as credit impaired. We critically assessed the latest information against criteria, as defined by management, for considering whether the borrower is credit impaired, or not.

For a sample of Stage 3 credit impaired loans, we:

- Evaluated the basis on which the allowance was determined, and the evidence supporting the analysis performed by management;
- We independently challenged whether the key assumptions used, such as the recovery strategies, collateral rights and ranges of potential outcomes, were appropriate, given the borrower's circumstances;
- Re-performed management's allowance calculation, assessing supporting evidence in relation to key inputs on a case by case basis, that included expected future cash flows, discount rates, valuations of collateral held, and the weightings applied to scenario outcomes; and
- Where relevant, we specifically considered whether valuations were up to date, and consistent with the strategy being followed in respect of the particular borrower and assessed the sensitivity to key assumptions used.

Based on the evidence assessed, we found the methodologies, modelled assumptions and data used within the allowance for ECL assessment to be materially appropriate and in line with the requirements of IFRS 9.

Hedge accounting
(Group and Bank)

Refer to page 33 (Note 2: Accounting policies) and pages 49 and 104 (Notes 14 and 42).

The Group enters into derivative contracts in order to manage and economically hedge risks such as interest and foreign exchange rate risk. These arrangements create accounting mismatches which are addressed through designating instruments into fair value or cash flow hedge accounting relationships.

Whilst there has been automation of hedging accounting processes in the period, the Group's application of hedge accounting in the year still relied upon a significant degree of manual processing, which increases the risk of operational errors and hence the risk that financial reporting is not compliant with IFRS requirements.

We understood and tested key controls over the designation and ongoing management of hedge accounting relationships, including those over hedge documentation, hedge effectiveness testing and the recording of hedge accounting adjustments.

We found these key controls were designed, implemented and operated effectively, and therefore determined that we could place reliance on these key controls for the purposes of our audit.

Our other testing included the following:

- Examining selected hedge documentation to assess whether it complies with the requirements of IFRS;
- Testing the key year-end reconciliations between underlying source systems and the models used to manage hedging relationships;
- Independently assessing whether management have captured and monitored all material sources of ineffectiveness, including any impact of the interest rate benchmark reform;
- Re-performing a sample of hedge effectiveness calculations;
- Re-performing a sample of capacity assessment calculations; and
- Testing a sample of manual adjustments posted to record ineffectiveness.

Based on the evidence obtained, we determined the application of hedge accounting to be appropriate.

Privileged access to IT systems (Group and Bank) The Group’s financial reporting processes are reliant on automated processes, controls and data managed by IT systems. As part of our audit work in prior periods, we identified control matters in relation to the management of IT privileged access to IT platforms supporting a subset of applications in-scope for financial reporting. While there is an ongoing programme of activities to address such control matters across the IT estate, the fact that these were open during the period meant there was a risk that automated functionality, reports or data from the specific systems are not reliable.	For the purposes of our audit, we validate the design, implementation and operating effectiveness of those automated and IT dependent controls that support the in-scope financial statement line items. We also review the supporting IT General Computer Controls (ITGCs) that provide assurance over the effective operation of these controls as well as those controls that manage the integrity of relevant data repositories for the full financial reporting period. We tested the design and operating effectiveness of those key controls identified that manage IT privileged access across the in-scope IT platforms. Specifically, we tested foundational controls over: – Approval, recertification and timely removal of access from IT systems; – The completeness and accuracy of the Access Controls Lists from IT platforms that are used by downstream IT security processes; In addition, we tested enhanced controls which act as mitigating controls on any gaps identified in the foundational controls: – The onboarding and management of IT privileged accounts through the privileged access ‘break-glass tool’ (including static IT privileged accounts); and – The monitoring of security events on IT platforms by the Security Operations Centre. As part of our review, we identified a number of entitlements that had not been recertified timely during the period. Consequently we performed an assessment of each of the areas within our audit approach where we place reliance on automated functionality and data within IT systems. In each case we identified a combination of mitigating IT controls, performed targeted audit procedures and assessed other mitigating factors (including business mitigating controls) in order to respond to the impact on our overall audit approach.
Impact of COVID-19 (Group and Bank) The global COVID-19 pandemic, and the associated societal restrictions imposed by the UK Government, have adversely affected the UK population and economy. The virus emerged in the UK in January 2020 and spread quickly, prompting the government to impose widespread restrictions on the population in March 2020, including the first national “lockdown”. Restrictions were eased and re-imposed throughout 2020 and in early 2021, including two further national lockdowns. At the time of issuing this report, the UK remains in its third lockdown. The UK government has deployed a range of support measures for people and businesses, and the Group has been active in some of these schemes, for example providing payment holidays and in issuing government backed loans. As at 31 December 2020, two vaccines have received regulatory approval and have begun to be administered to priority groups, such as the elderly. These, and the development of other vaccines, create an expectation that the restrictions will be eased in the foreseeable future. However, there remains significant uncertainty over the successful rollout and efficacy of the vaccines, the future mutation and spread of the virus, the extent and impact of government measures and economic outlook. The Group has kept most branches open throughout the pandemic, often with reduced hours. The majority of the Group’s other employees have been working remotely since March 2020. Management has considered the impact of COVID-19 when preparing the financial statements and, where relevant to a key audit matter or other area of this audit report, we have included our considerations therein.	Our planning and execution of our audit has given specific consideration to the impact of COVID-19 on the Group. In assessing management’s consideration of the impact of COVID-19 on the financial statements, we have undertaken the following procedures: – In areas where management is required to estimate future financial performance of the Group when preparing the financial statements, we have challenged the forecasts and the extent to which they have been impacted by COVID-19; – Performed inquiries with management and the Group’s regulators, the PRA and the FCA; – Assessed the impact of COVID-19 on estimates and the assumptions that underpin them, for example related to expected credit losses as detailed above; – Reviewed management’s going concern assessment, which considered the potential impact of COVID-19 on future profitability; – Considered the impact of COVID-19 on the Group’s internal control environment through our audit testing and inquiries of management; and – Evaluated the adequacy of the disclosures made in the financial statements with respect to the impact of COVID-19. As a result of these procedures, we concluded that the impact of COVID-19 has been appropriately evaluated and reflected in the preparation of the financial statements.

How we tailored the audit scope
We tailored the scope of our audit to ensure that we performed enough work to be able to give an opinion on the financial statements as a whole, taking into account the structure of the Group and the Bank, the accounting processes and controls, and the industry in which they operate.

The Group is structured into two segments being Retail and Commercial Banking. Each of the segments comprises a number of components. The consolidated financial statements are a consolidation of the components.

In establishing the overall approach to the Group audit, we determined the type of work that is required to be performed over the components by us, as the Group engagement team, or auditors within PwC UK and from other PwC network firms operating under our instruction (‘component auditors’). Almost all of our audit work is undertaken by PwC UK component auditors.

Where the work was performed by component auditors, we determined the level of involvement we needed to have in their audit work to be able to conclude whether sufficient appropriate audit evidence had been obtained as a basis for our opinion on the consolidated financial statements as a whole. This included regular communication with the component auditors throughout the audit, the issuance of instructions, a review of the results of their work on significant and elevated risk areas and formal clearance meetings.

Any components which were considered individually financially significant in the context of the Group's consolidated financial statements were considered full scope components. An individually financially significant component was deemed to be one which either represented more than or equal to 10% of the total assets of the consolidated Group, or represented more than or equal to 10% of the total liabilities of the consolidated Group, or whereby a component had a significant number of balances exceeding performance materiality. We have used appropriate judgement in determining what constitutes a "significant" number. We have also performed risk assessments over the significant and elevated risks identified in our audit plan to identify any additional individually financially significant components.

We considered the individual financial significance of other components in relation to primary statement account balances. We considered the presence of any significant audit risks and other qualitative factors (including history of misstatements through fraud or error). Any component which was not already included as a full scope component but was identified as being individually financially significant in respect of one or more account balances was subject to specific audit procedures over those specific account balances. Inconsequential components (defined as components which, in our judgement, did not present a reasonable possibility of a risk of material misstatement either individually or in aggregate) were eliminated from further consideration for specific audit procedures, although they were subject to Group level analytical review procedures. All remaining components which were neither inconsequential nor individually financially significant were subject to procedures which addressed the risk of material misstatement including testing of entity level controls, information technology general controls and Group and component level analytical review procedures.

Certain account balances were audited centrally by the Group engagement team.

Components within the scope of our audit contributed 99 per cent of Group total assets and 86 per cent of Group total income.

Materiality
The scope of our audit was influenced by our application of materiality. We set certain quantitative thresholds for materiality. These, together with qualitative considerations, helped us to determine the scope of our audit and the nature, timing and extent of our audit procedures on the individual financial statement line items and disclosures and in evaluating the effect of misstatements, both individually and in aggregate on the financial statements as a whole.

Based on our professional judgement, we determined materiality for the financial statements as a whole as follows:

	Group financial statements	Bank financial statements
Overall materiality	£120m (2019: £120m).	£120m (2019: £120m).
How we determined it	5 per cent of the four-year average adjusted profit before tax for the financial years ended 31 December 2017, 2018, 2019 and 2020, adjusted to remove the effects of certain items which were considered to have a disproportionate impact.	1 per cent of total assets but limited to the overall Group materiality.
Rationale for benchmark applied	Due to the impact of COVID-19 on profit for 2020, our starting point was 5 per cent of the average adjusted profit before tax across 2017, 2018, 2019 and 2020. Profit before tax was adjusted to remove the disproportionate effect of regulatory provisions as they are considered not to reflect the long-term performance of the Group.	We have selected total assets as an appropriate benchmark for Bank materiality. Profit based benchmarks are not considered the most appropriate for Bank materiality as the users of the Bank financial statements are primarily focused on the balance sheet. Where the calculated Bank materiality from total assets exceeds the Group overall materiality level, the Bank overall materiality has been restricted to equal the Group overall materiality level.

For each component in the scope of our Group audit, we allocated a materiality that is less than our overall Group materiality. The materiality allocated across components was £50m. Certain components were audited to a local statutory audit materiality that was also less than our overall Group materiality.

We use performance materiality to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds overall materiality. Specifically, we use performance materiality in determining the scope of our audit and the nature and extent of our testing of account balances, classes of transactions and disclosures, for example in determining sample sizes. Our performance materiality was £90m for the Group and Bank financial statements.

In determining the performance materiality, we considered a number of factors - the history of misstatements, risk assessment and aggregation risk and the effectiveness of controls - and concluded that an amount at the upper end of our normal range was appropriate.

We agreed with the Audit Committee that we would report to them misstatements identified during our audit above £12m (Group and Bank audit) (2019: £12m) as well as misstatements below those amounts that, in our view, warranted reporting for qualitative reasons.

Conclusions relating to going concern
Our evaluation of the directors' assessment of the Group's and the Bank's ability to continue to adopt the going concern basis of accounting included:

- Evaluation of management's going concern assessment;
- Evaluation and testing of the control environment in place over liquidity and capital forecasting to the extent these are relevant to the going concern assessments performed by the Group;
- Evaluation of stress testing performed by management and consideration of whether the stresses applied are appropriate for assessing going concern;
- Evaluation of the Group's forecast financial performance, liquidity and capital positions over the going concern period including an evaluation of the impact of COVID-19 on the financial outlook of the Group;
- Review of credit rating agency ratings and actions; and
- Substantiation of certain financial resources available to the Group, for example at the Bank of England.

Independent auditors' report

Based on the work we have performed, we have not identified any material uncertainties relating to events or conditions that, individually or collectively, may cast significant doubt on the Group's and the Bank's ability to continue as a going concern for a period of at least twelve months from when the financial statements are authorised for issue.

In auditing the financial statements, we have concluded that the directors' use of the going concern basis of accounting in the preparation of the financial statements is appropriate.

However, because not all future events or conditions can be predicted, this conclusion is not a guarantee as to the Group's and the Bank's ability to continue as a going concern.

Our responsibilities and the responsibilities of the directors with respect to going concern are described in the relevant sections of this report.

Reporting on other information
The other information comprises all of the information in the Annual Report other than the financial statements and our auditors' report thereon. The directors are responsible for the other information. Our opinion on the financial statements does not cover the other information and, accordingly, we do not express an audit opinion or, except to the extent otherwise explicitly stated in this report, any form of assurance thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit, or otherwise appears to be materially misstated. If we identify an apparent material inconsistency or material misstatement, we are required to perform procedures to conclude whether there is a material misstatement of the financial statements or a material misstatement of the other information. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact. We have nothing to report based on these responsibilities.

With respect to the Strategic report and Directors' report, we also considered whether the disclosures required by the UK Companies Act 2006 have been included.

Based on our work undertaken in the course of the audit, the Companies Act 2006 requires us also to report certain opinions and matters as described below.

Strategic report and Directors' report
In our opinion, based on the work undertaken in the course of the audit, the information given in the Strategic report and Directors' report for the year ended 31 December 2020 is consistent with the financial statements and has been prepared in accordance with applicable legal requirements.

In light of the knowledge and understanding of the Group and Bank and their environment obtained in the course of the audit, we did not identify any material misstatements in the Strategic report and Directors' report.

Responsibilities for the financial statements and the audit
Responsibilities of the directors for the financial statements
As explained more fully in the Statement of directors' responsibilities, the directors are responsible for the preparation of the financial statements in accordance with the applicable framework and for being satisfied that they give a true and fair view. The directors are also responsible for such internal control as they determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, the directors are responsible for assessing the Group's and the Bank's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless the directors either intend to liquidate the Group or the Bank or to cease operations, or have no realistic alternative but to do so.

Auditors' responsibilities for the audit of the financial statements
Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditors' report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs (UK) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

Our audit testing might include testing complete populations of certain transactions and balances, possibly using data auditing techniques. However, it typically involves selecting a limited number of items for testing, rather than testing complete populations. We will often seek to target particular items for testing based on their size or risk characteristics. In other cases, we will use audit sampling to enable us to draw a conclusion about the population from which the sample is selected.

A further description of our responsibilities for the audit of the financial statements is located on the FRC's website at: www.frc.org.uk/auditorsresponsibilities. This description forms part of our auditors' report.

Use of this report
This report, including the opinions, has been prepared for and only for the Bank's members as a body in accordance with Chapter 3 of Part 16 of the Companies Act 2006 and for no other purpose. We do not, in giving these opinions, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

Independent auditors' report

Other required reporting

Companies Act 2006 exception reporting

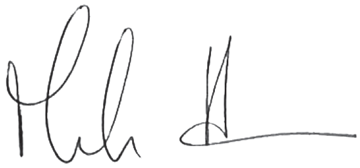
Under the Companies Act 2006 we are required to report to you if, in our opinion:

– we have not obtained all the information and explanations we require for our audit; or
– adequate accounting records have not been kept by the Bank, or returns adequate for our audit have not been received from branches not visited by us; or
– certain disclosures of directors' remuneration specified by law are not made; or
– the Bank financial statements are not in agreement with the accounting records and returns.

We have no exceptions to report arising from this responsibility.

Appointment

Following the recommendation of the Audit Committee, we were appointed by the members on 28 February 2009 to audit the financial statements for the year ended 31 December 2009 and subsequent financial periods. The period of total uninterrupted engagement is 12 years, covering the years ended 31 December 2009 to 31 December 2020. The audit was tendered in 2014 and we were re-appointed with effect from 1 January 2016. There will be a mandatory rotation for the 2021 audit and we will cease to be auditor of the Group.



Mark Hannam (Senior Statutory Auditor)
for and on behalf of PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors
London

11 March 2021

Consolidated income statement

for the year ended 31 December 2020

The Group	Note	2020 £ million	2019 £ million
Interest income		**7,565**	8,659
Interest expense		**(2,357)**	(3,231)
Net interest income	5	**5,208**	5,428
Fee and commission income		**468**	601
Fee and commission expense		**(269)**	(281)
Net fee and commission income	6	**199**	320
Net trading (losses) income	7	**(369)**	245
Other operating income	8	**109**	40
Other (losses) income		**(61)**	605
Total income		**5,147**	6,033
Regulatory provisions	28	**(107)**	(1,217)
Other operating expenses		**(2,535)**	(3,088)
Total operating expenses	9	**(2,642)**	(4,305)
Impairment	11	**(1,622)**	(450)
Profit before tax		**883**	1,278
Tax credit (expense)	12	**30**	(604)
Profit for the year		**913**	674

Profit attributable to ordinary shareholders		**749**	573
Profit attributable to other equity holders		**164**	101
Profit for the year		**913**	674

The accompanying notes are an integral part of the financial statements.

Statements of comprehensive income

for the year ended 31 December 2020

The Group	2020 £ million	2019 £ million
Profit for the year	**913**	674
Other comprehensive income		
Items that will not subsequently be reclassified to profit or loss:		
Post-retirement defined benefit scheme remeasurements:		
Remeasurements before tax	**22**	23
Tax	**(7)**	(6)
	15	17
Items that may subsequently be reclassified to profit or loss:		
Movement in revaluation reserve in respect of financial assets held at fair value through other comprehensive income – debt securities:		
Change in fair value	**24**	5
Income statement transfers in respect of disposals	**(10)**	–
Tax	**(2)**	(1)
	12	4
Movements in cash flow hedging reserve:		
Effective portion of changes in fair value taken to other comprehensive income	**(3)**	2
Net income statement transfers	**(4)**	37
Tax	**3**	(10)
	(4)	29
Movements in foreign currency translation reserve:		
Currency translation differences (tax: £nil)	**(7)**	(17)
Transfers to income statement (tax: £nil)	**–**	111
	(7)	94
Other comprehensive income for the year, net of tax	**16**	144
Total comprehensive income for the year	**929**	818

Total comprehensive income attributable to ordinary shareholders	**765**	717
Total comprehensive income attributable to other equity holders	**164**	101
Total comprehensive income for the year	**929**	818

The accompanying notes are an integral part of the financial statements

Statements of comprehensive income

for the year ended 31 December 2020

The Bank	2020 £ million	2019 £ million
Profit for the year	**915**	749
Other comprehensive income		
Items that will not subsequently be reclassified to profit or loss:		
Post-retirement defined benefit scheme remeasurements		
Remeasurements before tax	**22**	23
Tax	**(7)**	(6)
	15	17
Movements in revaluation reserve in respect of financial assets held at fair value through other comprehensive income – debt securities:		
Change in fair value	**25**	5
Income statement transfers in respect of disposals	**(10)**	–
Tax	**(4)**	(1)
	11	4
Movements in cash flow hedging reserve:		
Effective portion of changes in fair value taken to other comprehensive income	**(3)**	2
Net income statement transfers	**(4)**	37
Tax	**3**	(10)
	(4)	29
Movements in foreign currency translation reserve:		
Currency translation differences (tax: £nil)	**(8)**	(8)
Income statement transfers (tax: £nil)	**–**	(123)
	(8)	(131)
Other comprehensive income for the year, net of tax	**14**	(81)
Total comprehensive income for the year	**929**	668

Total comprehensive income attributable to ordinary shareholders	**765**	567
Total comprehensive income attributable to other equity holders	**164**	101
Total comprehensive income for the year	**929**	668

The accompanying notes are an integral part of the financial statements

Balance sheets

at 31 December 2020

		The Group		The Bank	
	Note	**31 December 2020 £ million**	31 December 2019 £ million	**31 December 2020 £ million**	31 December 2019 £ million
Assets					
Cash and balances at central banks		**2,841**	2,492	**2,841**	2,492
Items in the course of collection from banks		**42**	40	**42**	40
Financial assets at fair value through profit or loss	13	**477**	463	**158**	117
Derivative financial instruments	14	**7,423**	10,338	**7,423**	10,296
Loans and advances to banks	15	**207**	311	**205**	307
Loans and advances to customers	15	**263,766**	258,315	**259,697**	252,931
Due from fellow Lloyds Banking Group undertakings	15	**28,988**	97,534	**38,726**	108,935
Financial assets at amortised cost		**292,961**	356,160	**298,628**	362,173
Financial assets at fair value through other comprehensive income	17	**2,395**	2,253	**2,395**	2,253
Goodwill	18	**325**	325	**325**	325
Other intangible assets	19	**224**	138	**224**	138
Property, plant and equipment	20	**1,230**	1,407	**1,226**	1,374
Current tax recoverable		**356**	104	**395**	166
Deferred tax assets	27	**1,721**	1,652	**1,718**	1,647
Retirement benefit assets		**69**	46	**69**	46
Investment in subsidiary undertakings	21	**–**	–	**74**	74
Other assets	22	**264**	356	**246**	361
Total assets		**310,328**	375,774	**315,764**	381,502

The accompanying notes are an integral part of the consolidated financial statements.

Balance sheets

at 31 December 2020

Equity and liabilities	Note	The Group 31 December 2020 £ million	The Group 31 December 2019 £ million	The Bank 31 December 2020 £ million	The Bank 31 December 2019 £ million
Liabilities					
Deposits from banks		**14,695**	16,472	**14,694**	16,472
Customer deposits		**163,001**	151,845	**163,000**	151,818
Due to fellow Lloyds Banking Group undertakings		**91,953**	161,618	**99,612**	169,813
Items in course of transmission to banks		**98**	143	**98**	143
Financial liabilities at fair value through profit or loss	23	**45**	47	**–**	–
Derivative financial instruments	14	**8,672**	11,352	**8,360**	11,048
Notes in circulation		**1,305**	1,079	**1,305**	1,079
Debt securities in issue	24	**8,297**	11,204	**7,012**	9,700
Other liabilities	26	**1,389**	1,831	**1,220**	1,679
Current tax liabilities		**–**	15	**10**	9
Other provisions	28	**521**	977	**519**	968
Subordinated liabilities	29	**6,964**	6,101	**6,964**	6,101
Total liabilities		**296,940**	362,684	**302,794**	368,830
Equity					
Share capital	30	**5,847**	5,847	**5,847**	5,847
Other reserves	31	**2,020**	2,019	**2,046**	2,047
Retained profits[1]	32	**3,313**	2,516	**2,877**	2,078
Shareholders' equity		**11,180**	10,382	**10,770**	9,972
Other equity instruments	33	**2,200**	2,700	**2,200**	2,700
Total equity excluding non-controlling interests		**13,380**	13,082	**12,970**	12,672
Non-controlling interests		**8**	8	**–**	–
Total equity		**13,388**	13,090	**12,970**	12,672
Total equity and liabilities		**310,328**	375,774	**315,764**	381,502

1 The Bank recorded a profit after tax for the year of £915 million (2019: £749 million).

The accompanying notes are an integral part of the financial statements.

The directors approved the financial statements on 11 March 2021.

Robin Budenberg
Chair

António Horta-Osório
Chief Executive

William Chalmers
Chief Financial Officer

Statements of changes in equity

for the year ended 31 December 2020

The Group	Attributable to ordinary shareholders Share capital £ million	Other reserves £ million	Retained profits £ million	Total £ million	Other equity instruments £ million	Non-controlling interests £ million	Total £ million
At 1 January 2019	5,847	1,892	2,373	10,112	1,500	8	11,620
Comprehensive income							
Profit for the year	–	–	573	573	101	–	674
Other comprehensive income							
Movements in revaluation reserve in respect of debt securities held at fair value through other comprehensive income, net of tax	–	–	17	17	–	–	17
Movements in revaluation reserve in respect of equity shares held at fair value through other comprehensive income, net of tax	–	4	–	4	–	–	4
Movements in cash flow hedging reserve, net of tax	–	29	–	29	–	–	29
Currency translation differences, net of tax	–	94	–	94	–	–	94
Total other comprehensive income	–	127	17	144	–	–	144
Total comprehensive income	–	127	590	717	101	–	818
Transactions with owners							
Dividends (note 34)	–	–	(500)	(500)	–	–	(500)
Distributions on other equity instruments	–	–	–	–	(101)	–	(101)
Issue of other equity instruments	–	–	–	–	1,200	–	1,200
Capital contributions received	–	–	53	53	–	–	53
Total transactions with owners	–	–	(447)	(447)	1,099	–	652
At 31 December 2019	5,847	2,019	2,516	10,382	2,700	8	13,090
Comprehensive income							
Profit for the year	**–**	**–**	**749**	**749**	**164**	**–**	**913**
Other comprehensive income							
Post-retirement defined benefit scheme remeasurements, net of tax	**–**	**–**	**15**	**15**	**–**	**–**	**15**
Movements in revaluation reserve in respect of debt securities held at fair value through other comprehensive income, net of tax	**–**	**12**	**–**	**12**	**–**	**–**	**12**
Movements in cash flow hedging reserve, net of tax	**–**	**(4)**	**–**	**(4)**	**–**	**–**	**(4)**
Currency translation differences, net of tax	**–**	**(7)**	**–**	**(7)**	**–**	**–**	**(7)**
Total other comprehensive income	**–**	**1**	**15**	**16**	**–**	**–**	**16**
Total comprehensive income	**–**	**1**	**764**	**765**	**164**	**–**	**929**
Transactions with owners							
Distributions on other equity instruments	**–**	**–**	**–**	**–**	**(164)**	**–**	**(164)**
Issue of other equity instruments	**–**	**–**	**–**	**–**	**1,000**	**–**	**1,000**
Redemption of other equity instruments	**–**	**–**	**–**	**–**	**(1,500)**	**–**	**(1,500)**
Capital contributions received	**–**	**–**	**33**	**33**	**–**	**–**	**33**
Total transactions with owners	**–**	**–**	**33**	**33**	**(664)**	**–**	**(631)**
At 31 December 2020	**5,847**	**2,020**	**3,313**	**11,180**	**2,200**	**8**	**13,388**

Further details of movements in the Group's share capital and reserves are provided in notes 30, 31, 32 and 33.

The accompanying notes are an integral part of the financial statements.

Statements of changes in equity

for the year ended 31 December 2020

The Bank	Share capital £ million	Other reserves £ million	Retained profits £ million	Shareholder equity £ million	Other equity instruments £ million	Total £ million
At 1 January 2019	5,847	2,145	1,860	9,852	1,500	11,352
Comprehensive income						
Profit for the year	–	–	648	648	101	749
Other comprehensive income						
Post-retirement defined benefit scheme remeasurements, net of tax:	–	–	17	17	–	17
Movements in revaluation reserve in respect of debt securities held at fair value through other comprehensive income, net of tax	–	4	–	4	–	4
Movements in cash flow hedging reserve, net of tax	–	29	–	29	–	29
Currency translation differences, net of tax	–	(131)	–	(131)	–	(131)
Total other comprehensive income	–	(98)	17	(81)	–	(81)
Total comprehensive income	–	(98)	665	567	101	668
Transactions with owners						
Dividends (note 34)	–	–	(500)	(500)	–	(500)
Distributions on other equity instruments	–	–	–	–	(101)	(101)
Issue of other equity instruments	–	–	–	–	1,200	1,200
Capital contributions received	–	–	53	53	–	53
Total transactions with owners	–	–	(447)	(447)	1,099	652
At 31 December 2019	5,847	2,047	2,078	9,972	2,700	12,672
Comprehensive income						
Profit for the year	**–**	**–**	**751**	**751**	**164**	**915**
Other comprehensive income						
Post-retirement defined benefit scheme remeasurements, net of tax	**–**	**–**	**15**	**15**	**–**	**15**
Movements in revaluation reserve in respect of debt securities held at fair value through other comprehensive income, net of tax	**–**	**11**	**–**	**11**	**–**	**11**
Movements in cash flow hedging reserve, net of tax	**–**	**(4)**	**–**	**(4)**	**–**	**(4)**
Currency translation differences, net of tax	**–**	**(8)**	**–**	**(8)**	**–**	**(8)**
Total other comprehensive income	**–**	**(1)**	**15**	**14**	**–**	**14**
Total comprehensive income	**–**	**(1)**	**766**	**765**	**164**	**929**
Transactions with owners						
Distributions on other equity instruments	**–**	**–**	**–**	**–**	**(164)**	**(164)**
Issue of other equity instruments	**–**	**–**	**–**	**–**	**1,000**	**1,000**
Redemption of other equity instruments	**–**	**–**	**–**	**–**	**(1,500)**	**(1,500)**
Capital contributions received	**–**	**–**	**33**	**33**	**–**	**33**
Total transactions with owners	**–**	**–**	**33**	**33**	**(664)**	**(631)**
At 31 December 2020	**5,847**	**2,046**	**2,877**	**10,770**	**2,200**	**12,970**

Further details of movements in the Bank's share capital and reserves are provided in notes 30, 31, 32 and 33.

The accompanying notes are an integral part of the financial statements.

Cash flow statements

for the year ended 31 December 2020

		The Group		The Bank	
	Note	**2020 £ million**	2019 £ million	**2020 £ million**	2019 £ million
Profit before tax		**883**	1,278	**890**	1,329
Adjustments for:					
Change in operating assets	44(a)	**64,868**	(35,720)	**65,126**	(36,375)
Change in operating liabilities	44(b)	**(66,150)**	35,483	**(66,463)**	36,169
Non-cash and other items	44(c)	**1,052**	803	**1,036**	651
Tax paid		**(313)**	(554)	**(282)**	(523)
Net cash provided by operating activities		**340**	1,290	**307**	1,251
Cash flows from investing activities					
Purchase of financial assets		**(745)**	(1,360)	**(745)**	(1,360)
Proceeds from sale and maturity of financial assets		**624**	184	**624**	184
Dividends received from subsidiaries		**–**	–	**45**	83
Purchase of fixed assets		**(179)**	(233)	**(170)**	(220)
Proceeds from sale of fixed assets		**20**	67	**1**	6
Net cash used in investing activities		**(280)**	(1,342)	**(245)**	(1,307)
Cash flows from financing activities					
Dividends paid to ordinary shareholders	34	**–**	(500)	**–**	(500)
Distributions on other equity instruments		**(164)**	(101)	**(164)**	(101)
Interest paid on subordinated liabilities		**(146)**	(210)	**(146)**	(210)
Proceeds from issue of subordinated liabilities		**1,000**	–	**1,000**	–
Proceeds from issue of other equity instruments		**1,000**	1,200	**1,000**	1,200
Repayment of subordinated liabilities		**(161)**	(578)	**(161)**	(578)
Redemption of other equity instruments		**(1,500)**	–	**(1,500)**	–
Net cash provided by (used in) financing activities		**29**	(189)	**29**	(189)
Effects of exchange rate changes on cash and cash equivalents		**1**	(3)	**1**	(3)
Change in cash and cash equivalents		**90**	(244)	**92**	(248)
Cash and cash equivalents at beginning of year		**759**	1,003	**755**	1,003
Cash and cash equivalents at end of year	44(d)	**849**	759	**847**	755

The accompanying notes are an integral part of the consolidated financial statements.

Notes to the accounts

1 Basis of preparation

These financial statements comply with international accounting standards in conformity with the requirements of the Companies Act 2006 and have been prepared in accordance with International Financial Reporting Standards (IFRS). IFRS comprises accounting standards prefixed IFRS issued by the International Accounting Standards Board (IASB) and those prefixed IAS issued by the IASB's predecessor body as well as interpretations issued by the IFRS Interpretations Committee and its predecessor body. On adoption of IFRS 9 in 2018, the Bank (Bank of Scotland plc) and the Group (the Bank and its subsidiary undertakings) elected to continue applying hedge accounting under IAS 39. The financial statements are also compliant with IFRS adopted pursuant to Regulation (EC) No 1606/2002 as it applies in the European Union. The EU endorsed version of IAS 39 *Financial Instruments: Recognition and Measurement* relaxes some of the hedge accounting requirements; the Group has not taken advantage of this relaxation, and therefore there is no difference in application to the Group between IFRS as adopted by the EU and IFRS as issued by the IASB.

The financial information has been prepared under the historical cost convention, as modified by the revaluation of investment properties, financial assets measured at fair value through other comprehensive income, trading securities and certain other financial assets and liabilities at fair value through profit or loss and all derivative contracts.

The capital resources disclosure required under IFRS has been included within the Strategic Report on page 3. This disclosure is covered by the Audit opinion (included on pages 16 to 24) and referenced as audited.

The directors consider that it is appropriate to continue to adopt the going concern basis in preparing the financial statements. In reaching this assessment, the directors have considered the implications of the COVID-19 pandemic upon the Group's performance and projected funding and capital position and have also taken into account the impact of further stress scenarios. On this basis, the directors are satisfied that the Group will maintain adequate levels of funding and capital for the foreseeable future. Further details of the Group's funding and capital position are set out on page 119.

Details of those IFRS pronouncements which will be relevant to the Group but which were not effective at 31 December 2020 and which have not been applied in preparing these financial statements are given in note 45.

In 2019 the Group adopted IFRS 16 and amendments to IAS 12 and early-adopted the hedge accounting amendments *Interest Rate Benchmark Reform* issued by the IASB.

---

2 Accounting policies

The accounting policies are set out below. These accounting policies have been applied consistently.

(A) Consolidation
The assets, liabilities and results of Group undertakings (including structured entities) are included in the financial statements on the basis of accounts made up to the reporting date. Group undertakings include subsidiaries, associates and joint ventures. Details of the Group's subsidiaries and related undertakings are given on pages 122 to 123.

(1) Subsidiaries
Subsidiaries are entities controlled by the Group. The Group controls an entity when it has power over the entity, is exposed to, or has rights to, variable returns from its involvement with the entity, and has the ability to affect those returns through the exercise of its power. This generally accompanies a shareholding of more than one half of the voting rights although in certain circumstances a holding of less than one half of the voting rights may still result in the ability of the Group to exercise control. The existence and effect of potential voting rights that are currently exercisable or convertible are considered when assessing whether the Group controls another entity. The Group reassesses whether or not it controls an entity if facts and circumstances indicate that there are changes to any of the above elements. Subsidiaries are fully consolidated from the date on which control is transferred to the Group; they are de-consolidated from the date that control ceases.

Structured entities are entities that are designed so that their activities are not governed by way of voting rights. In assessing whether the Group has power over such entities in which it has an interest, the Group considers factors such as the purpose and design of the entity; its practical ability to direct the relevant activities of the entity; the nature of the relationship with the entity; and the size of its exposure to the variability of returns of the entity.

2 Accounting policies (continued)

The treatment of transactions with non-controlling interests depends on whether, as a result of the transaction, the Group loses control of the subsidiary. Changes in the parent's ownership interest in a subsidiary that do not result in a loss of control are accounted for as equity transactions; any difference between the amount by which the non-controlling interests are adjusted and the fair value of the consideration paid or received is recognised directly in equity and attributed to the owners of the parent entity. Where the Group loses control of the subsidiary, at the date when control is lost the amount of any non-controlling interest in that former subsidiary is derecognised and any investment retained in the former subsidiary is remeasured to its fair value; the gain or loss that is recognised in profit or loss on the partial disposal of the subsidiary includes the gain or loss on the remeasurement of the retained interest.

Intercompany transactions, balances and unrealised gains and losses on transactions between Group companies are eliminated.

The acquisition method of accounting is used to account for business combinations by the Group. The consideration for the acquisition of a subsidiary is the fair value of the assets transferred, the liabilities incurred and the equity interests issued by the Group. The consideration includes the fair value of any asset or liability resulting from a contingent consideration arrangement. Acquisition related costs are expensed as incurred except those relating to the issuance of debt instruments (see (E)(4) below) or share capital (see (O) below). Identifiable assets acquired and liabilities assumed in a business combination are measured initially at their fair value at the acquisition date.

(2) Joint ventures and associates
Joint ventures are joint arrangements over which the Group has joint control with other parties and has rights to the net assets of the arrangements. Joint control is the contractually agreed sharing of control of an arrangement and only exists when decisions about the relevant activities require the unanimous consent of the parties sharing control. Associates are entities over which the Group has significant influence. Significant influence is the power to participate in the financial and operating policy decisions of the entity, but is not control or joint control of those policies, and is generally achieved through holding between 20 per cent and 50 per cent of the voting share capital of the entity.

The Group utilises the venture capital exemption for investments where significant influence or joint control is present and the business unit operates as a venture capital business. These investments are designated at initial recognition at fair value through profit or loss. Otherwise, the Group's investments in joint ventures and associates are accounted for by the equity method of accounting.

(B) Goodwill
Goodwill arises on business combinations and represents the excess of the cost of an acquisition over the fair value of the Group's share of the identifiable assets, liabilities and contingent liabilities acquired. Where the fair value of the Group's share of the identifiable assets, liabilities and contingent liabilities of the acquired entity is greater than the cost of acquisition, the excess is recognised immediately in the income statement.

Goodwill is recognised as an asset at cost and is tested at least annually for impairment. If an impairment is identified the carrying value of the goodwill is written down immediately through the income statement and is not subsequently reversed. At the date of disposal of a subsidiary, the carrying value of attributable goodwill is included in the calculation of the profit or loss on disposal.

(C) Other intangible assets
Intangible assets which have been determined to have a finite useful life are amortised on a straight line basis over their estimated useful life as follows: up to 7 years for capitalised software; 10 to 15 years for brands and other intangible assets.

Intangible assets with finite useful lives are reviewed at each reporting date to assess whether there is any indication that they are impaired. If any such indication exists the recoverable amount of the asset is determined and in the event that the asset's carrying amount is greater than its recoverable amount, it is written down immediately.

(D) Revenue recognition
(1) Net interest income
Interest income and expense are recognised in the income statement using the effective interest method for all interest-bearing financial instruments, except for those classified at fair value through profit or loss. The effective interest method is a method of calculating the amortised cost of a financial asset or liability and of allocating the interest income or interest expense over the expected life of the financial instrument. The effective interest rate is the rate that exactly discounts the estimated future cash payments or receipts over the expected life of the financial instrument to the gross carrying amount of the financial asset (before adjusting for expected credit losses) or to the amortised cost of the financial liability, including early redemption fees, and related penalties, and premiums and discounts that are an integral part of the overall return. Direct incremental transaction costs related to the acquisition, issue or disposal of a financial instrument are also taken into account. Interest income from non-credit impaired financial assets is recognised by applying the effective interest rate to the gross carrying amount of the asset; for credit impaired financial assets, the effective interest rate is applied to the net carrying amount after deducting the allowance for expected credit losses. Impairment policies are set out in (H) below.

(2) Fee and commission income and expense
Fees and commissions receivable which are not an integral part of the effective interest rate are recognised as income as the Group fulfils its performance obligations. The Group's principal performance obligations arising from contracts with customers are in respect of value added current accounts, credit cards and debit cards. These fees are received, and the Group's provides the service, monthly; the fees are recognised in income on this basis. The Group also receives certain fees in respect of its asset finance business where the performance obligations are typically fulfilled towards the end of the customer contract; these fees are recognised in income on this basis. Where it is unlikely that the loan commitments will be drawn, loan commitment fees are recognised in fee and commission income over the life of the facility, rather than as an adjustment to the effective interest rate for loans expected to be drawn. Incremental costs incurred to generate fee and commission income are charged to fees and commissions expense as they are incurred.

(3) Other
Dividend income is recognised when the right to receive payment is established.

Revenue recognition policies specific to trading income are set out in (E)(3) below; those relating to leases are set out in (J)(1) below.

(E) Financial assets and liabilities
On initial recognition, financial assets are classified as measured at amortised cost, fair value through other comprehensive income or fair value through profit or loss, depending on the Group's business model for managing the financial assets and whether the cash flows represent solely payments of principal and interest. The Group assesses its business models at a portfolio level based on its objectives for the relevant portfolio, how the performance of the portfolio is managed and reported, and the frequency of asset sales. Financial assets with embedded derivatives are considered in their entirety when considering their cash

2 Accounting policies (continued)

flow characteristics. The Group reclassifies financial assets when and only when its business model for managing those assets changes. A reclassification will only take place when the change is significant to the Group's operations and will occur at a portfolio level and not for individual instruments; reclassifications are expected to be rare.

The Group initially recognises loans and advances, deposits, debt securities in issue and subordinated liabilities when the Group becomes a party to the contractual provisions of the instrument. Regular way purchases and sales of securities and other financial assets and trading liabilities are recognised on trade date, being the date that the Group is committed to purchase or sell an asset.

Financial assets are derecognised when the contractual right to receive cash flows from those assets has expired or when the Group has transferred its contractual right to receive the cash flows from the assets and either: substantially all of the risks and rewards of ownership have been transferred; or the Group has neither retained nor transferred substantially all of the risks and rewards, but has transferred control.

Financial liabilities are derecognised when the obligation is discharged, cancelled or expires.

(1) Financial instruments measured at amortised cost
Financial assets that are held to collect contractual cash flows where those cash flows represent solely payments of principal and interest are measured at amortised cost. A basic lending arrangement results in contractual cash flows that are solely payments of principal and interest on the principal amount outstanding. Where the contractual cash flows introduce exposure to risks or volatility unrelated to a basic lending arrangement such as changes in equity prices or commodity prices, the payments do not comprise solely principal and interest. Financial assets measured at amortised cost are predominantly loans and advances to customers and banks. Loans and advances are initially recognised when cash is advanced to the borrower at fair value inclusive of transaction costs. Interest income is accounted for using the effective interest method (see (D) above).

Financial liabilities are measured at amortised cost, except for financial liabilities designated at fair value through profit or loss on initial recognition which are held at fair value.

(2) Financial assets measured at fair value through other comprehensive income
Financial assets that are held to collect contractual cash flows and for subsequent sale, where the assets' cash flows represent solely payments of principal and interest, are recognised in the balance sheet at their fair value, inclusive of transaction costs. Interest calculated using the effective interest method and foreign exchange gains and losses on assets denominated in foreign currencies are recognised in the income statement. All other gains and losses arising from changes in fair value are recognised directly in other comprehensive income, until the financial asset is either sold or matures, at which time the cumulative gain or loss previously recognised in other comprehensive income is recognised in the income statement other than in respect of equity shares, for which the cumulative revaluation amount is transferred directly to retained profits. The Group recognises a charge for expected credit losses in the income statement (see (H) below). As the asset is measured at fair value, the charge does not adjust the carrying value of the asset, it is reflected in other comprehensive income.

(3) Financial instruments measured at fair value through profit or loss
Financial assets are classified at fair value through profit or loss where they do not meet the criteria to be measured at amortised cost or fair value through other comprehensive income or where they are designated at fair value through profit or loss to reduce an accounting mismatch. All derivatives are carried at fair value through profit or loss.

Financial assets measured at fair value through profit or loss are recognised in the balance sheet at their fair value. Fair value gains and losses together with interest coupons and dividend income are recognised in the income statement within net trading income.

Financial liabilities are measured at fair value through profit or loss where they are designated at fair value through profit or loss in order to reduce an accounting mismatch; where the liabilities are part of a group of liabilities (or assets and liabilities) which is managed, and its performance evaluated, on a fair value basis; or where the liabilities contain one or more embedded derivatives that significantly modify the cash flows arising under the contract and would otherwise need to be separately accounted for. Financial liabilities measured at fair value through profit or loss are recognised in the balance sheet at their fair value. Fair value gains and losses are recognised in the income statement within net trading income in the period in which they occur.

The fair values of assets and liabilities traded in active markets are based on current bid and offer prices respectively. If the market is not active the Group establishes a fair value by using valuation techniques. The fair values of derivative financial instruments are adjusted where appropriate to reflect credit risk (via credit valuation adjustments (CVAs), debit valuation adjustments (DVAs) and funding valuation adjustments (FVAs)), market liquidity and other risks.

(4) Borrowings
Borrowings (which include deposits from banks, customer deposits, debt securities in issue and subordinated liabilities) are recognised initially at fair value, being their issue proceeds net of transaction costs incurred. These instruments are subsequently stated at amortised cost using the effective interest method.

Preference shares and other instruments which carry a mandatory coupon or are redeemable on a specific date are classified as financial liabilities. The coupon on these instruments is recognised in the income statement as interest expense. Securities which carry a discretionary coupon and have no fixed maturity or redemption date are classified as other equity instruments. Interest payments on these securities are recognised, as distributions from equity in the period in which they are paid. An exchange of financial liabilities on substantially different terms is accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. The difference between the carrying amount of a financial liability extinguished and the new financial liability is recognised in profit or loss together with any related costs or fees incurred.

When a financial liability is exchanged for an equity instrument, the new equity instrument is recognised at fair value and any difference between the carrying value of the liability and the fair value of the new equity is recognised in profit or loss.

(5) Sale and repurchase agreements (including securities lending and borrowing)
Securities sold subject to repurchase agreements (repos) continue to be recognised on the balance sheet where substantially all of the risks and rewards are retained. Funds received under these arrangements are included in deposits from banks, customer deposits, or trading liabilities. Conversely, securities purchased under agreements to resell (reverse repos), where the Group does not acquire substantially all of the risks and rewards of ownership, are recorded as loans and advances measured at amortised cost or trading securities. The difference between sale and repurchase price is treated as interest and accrued over the life of the agreements using the effective interest method.

Securities borrowing and lending transactions are typically secured; collateral takes the form of securities or cash advanced or received. Securities lent to counterparties are retained on the balance sheet. Securities borrowed are not recognised on the balance sheet, unless these are sold to third parties, in which

2 Accounting policies (continued)

case the obligation to return them is recorded at fair value as a trading liability. Cash collateral given or received is treated as a loan and advance measured at amortised cost or customer deposit.

(F) Derivative financial instruments and hedge accounting
As permitted by IFRS 9, the Group continues to apply the requirements of IAS 39 to its hedging relationships. All derivatives are recognised at their fair value. Derivatives are carried on the balance sheet as assets when their fair value is positive and as liabilities when their fair value is negative. Refer to note 39 (3) (Financial instruments: Financial assets and liabilities carried at fair value) for details of valuation techniques and significant inputs to valuation models.

Changes in the fair value of all derivative instruments, other than those in effective cash flow and net investment hedging relationships, are recognised immediately in the income statement. As noted in (2) and (3) below, the change in fair value of a derivative in an effective cash flow or net investment hedging relationship is allocated between the income statement and other comprehensive income.

Derivatives embedded in a financial asset are not considered separately; the financial asset is considered in its entirety when determining whether its cash flows are solely payments of principal and interest. Derivatives embedded in financial liabilities treated as separate derivatives when their economic characteristics and risks are not closely related to those of the host contract and the host contract is not carried at fair value through profit or loss. These embedded derivatives are measured at fair value with changes in fair value recognised in the income statement.

Hedge accounting allows one financial instrument, generally a derivative such as a swap, to be designated as a hedge of another financial instrument such as a loan or deposit or a portfolio of such instruments. At the inception of the hedge relationship, formal documentation is drawn up specifying the hedging strategy, the hedged item, the hedging instrument and the methodology that will be used to measure the effectiveness of the hedge relationship in offsetting changes in the fair value or cash flow of the hedged risk. The effectiveness of the hedging relationship is tested both at inception and throughout its life and if at any point it is concluded that it is no longer highly effective in achieving its documented objective, hedge accounting is discontinued. Note 14 provides details of the types of derivatives held by the Group and presents separately those designated in hedge relationships.

Where there is uncertainty arising from interest rate benchmark reform, the Group assumes that the interest rate benchmark on which the hedged cash flows and/or the hedged risk are based, or the interest rate benchmark on which the cash flows of the hedging instrument are based, are not altered as a result of interest rate benchmark reform. The Group does not discontinue a hedging relationship during the period of uncertainty arising from the interest rate benchmark reform solely because the actual results of the hedge are not highly effective.

(1) Fair value hedges
Changes in the fair value of derivatives that are designated and qualify as fair value hedges are recorded in the income statement, together with the changes in the fair value of the hedged asset or liability that are attributable to the hedged risk; this also applies if the hedged asset is classified as a financial asset at fair value through other comprehensive income. If the hedge no longer meets the criteria for hedge accounting, changes in the fair value of the hedged item attributable to the hedged risk are no longer recognised in the income statement. The cumulative adjustment that has been made to the carrying amount of the hedged item is amortised to the income statement using the effective interest method over the period to maturity.

(2) Cash flow hedges
The effective portion of changes in the fair value of derivatives that are designated and qualify as cash flow hedges is recognised in other comprehensive income in the cash flow hedging reserve. The gain or loss relating to the ineffective portion is recognised immediately in the income statement. Amounts accumulated in equity are reclassified to the income statement in the periods in which the hedged item affects profit or loss. When a hedging instrument expires or is sold, or when a hedge no longer meets the criteria for hedge accounting, any cumulative gain or loss existing in equity at that time remains in equity and is recognised in the income statement when the forecast transaction is ultimately recognised in the income statement. When a forecast transaction is no longer expected to occur, the cumulative gain or loss that was reported in equity is immediately transferred to the income statement.

(G) Offset
Financial assets and liabilities are offset and the net amount reported in the balance sheet when there is a legally enforceable right of offset and there is an intention to settle on a net basis, or realise the asset and settle the liability simultaneously. Cash collateral on exchange traded derivative transactions is presented gross unless the collateral cash flows are always settled net with the derivative cash flows. In certain situations, even though master netting agreements exist, the lack of management intention to settle on a net basis results in the financial assets and liabilities being reported gross on the balance sheet.

(H) Impairment of financial assets
The impairment charge in the income statement includes the change in expected credit losses and including those arising from fraud. Expected credit losses are recognised for loans and advances to customers and banks, other financial assets held at amortised cost, financial assets measured at fair value through other comprehensive income, and certain loan commitments and financial guarantee contracts. Expected credit losses are calculated as an unbiased and probability-weighted estimate using an appropriate probability of default, adjusted to take into account a range of possible future economic scenarios, and applying this to the estimated exposure of the Group at the point of default after taking into account the value of any collateral held, repayments, or other mitigants of loss and including the impact of discounting using the effective interest rate.

At initial recognition, allowance (or provision in the case of some loan commitments and financial guarantees) is made for expected credit losses resulting from default events that are possible within the next 12 months (12-month expected credit losses). In the event of a significant increase in credit risk since origination, allowance (or provision) is made for expected credit losses resulting from all possible default events over the expected life of the financial instrument (lifetime expected credit losses). Financial assets where 12-month expected credit losses are recognised are considered to be Stage 1; financial assets which are considered to have experienced a significant increase in credit risk since initial recognition are in Stage 2; and financial assets which have defaulted or are otherwise considered to be credit impaired are allocated to Stage 3. Some Stage 3 assets, mainly commercial loans, are subject to individual rather than collective assessment. Such cases are subject to a risk-based impairment sanctioning process, and these are reviewed and updated at least quarterly, or more frequently if there is a significant change in the credit profile. The collective assessment of impairment aggregates financial instruments with similar risk characteristics such as whether the facility is revolving in nature or secured and the type of security against financial assets.

An assessment of whether credit risk has increased significantly since initial recognition considers the change in the risk of default occurring over the remaining expected life of the financial instrument. In determining whether there has been a significant increase in credit risk, the Group uses quantitative tests based on relative and absolute probability of default (PD) movements linked to internal credit ratings together with qualitative indicators such as watchlists and other indicators of historical delinquency, credit weakness or financial difficulty. The use of internal credit ratings and qualitative indicators ensure alignment between the assessment of staging and the Group's management of credit risk which utilises these internal metrics within distinct retail and commercial portfolio risk management practices. However, unless identified at an earlier stage, the credit risk of financial assets is deemed to have increased significantly when more than

2 Accounting policies (continued)

30 days past due. The use of a payment holiday in itself has not been judged to indicate a significant increase in credit risk, with the underlying long-term credit risk deemed to be driven by economic conditions and captured through the use of forward-looking models. These portfolio level models are capturing the anticipated volume of increased defaults and therefore an appropriate assessment of staging and expected credit loss. Where the credit risk subsequently improves such that it no longer represents a significant increase in credit risk since initial recognition, the asset is transferred back to Stage 1.

Assets are transferred to Stage 3 when they have defaulted or are otherwise considered to be credit impaired. Default is considered to have occurred when there is evidence that the customer is experiencing financial difficulty which is likely to affect significantly the ability to repay the amount due. IFRS 9 contains a rebuttable presumption that default occurs no later than when a payment is 90 days past due. The Group uses this 90 day backstop for all its products except for UK mortgages. For UK mortgages, the Group uses a backstop of 180 days past due as mortgage exposures more than 90 days past due, but less than 180 days, typically show high cure rates and this aligns with the Group's risk management practices. Key differences between Stage 3 balances and non-performing loans relate to the use of 180 days past due for Stage 3 mortgages and to the cure periods applied to forbearance exposures. The use of payment holidays is not considered to be an automatic trigger of regulatory default and therefore does not automatically trigger Stage 3. Days past due will also not accumulate on any accounts that have taken a payment holiday including those already past due.

In certain circumstances, the Group will renegotiate the original terms of a customer's loan, either as part of an ongoing customer relationship or in response to adverse changes in the circumstances of the borrower. In the latter circumstances, the loan will remain classified as either Stage 2 or Stage 3 until the credit risk has improved such that it no longer represents a significant increase since origination (for a return to Stage 1), or the loan is no longer credit impaired (for a return to Stage 2). On renegotiation the gross carrying amount of the loan is recalculated as the present value of the renegotiated or modified contractual cash flows, which are discounted at the original effective interest rate. Renegotiation may also lead to the loan and associated allowance being derecognised and a new loan being recognised initially at fair value.

A loan or advance is normally written off, either partially or in full, against the related allowance when the proceeds from realising any available security have been received or there is no realistic prospect of recovery and the amount of the loss has been determined. Subsequent recoveries of amounts previously written off decrease the amount of impairment losses recorded in the income statement. For both secured and unsecured retail balances, the write-off takes place only once an extensive set of collections processes has been completed, or the status of the account reaches a point where policy dictates that continuing attempts to recover are no longer appropriate. For commercial lending, a write-off occurs if the loan facility with the customer is restructured, the asset is under administration and the only monies that can be received are the amounts estimated by the administrator, the underlying assets are disposed and a decision is made that no further settlement monies will be received, or external evidence (for example, third party valuations) is available that there has been an irreversible decline in expected cash flows.

(I) Property, plant and equipment
Property, plant and equipment (other than investment property) is included at cost less accumulated depreciation. The value of land (included in premises) is not depreciated. Depreciation on other assets is calculated using the straight-line method to allocate the difference between the cost and the residual value over their estimated useful lives, as follows: the shorter of 50 years and the remaining period of the lease for freehold/long and short leasehold premises; the shorter of 10 years and, if lease renewal is not likely, the remaining period of the lease for leasehold improvements; 10 to 20 years for fixtures and furnishings; and 2 to 8 years for other equipment and motor vehicles.

The assets' residual values and useful lives are reviewed, and adjusted if appropriate, at each balance sheet date.

Assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. In the event that an asset's carrying amount is determined to be greater than its recoverable amount it is written down immediately. The recoverable amount is the higher of the asset's fair value less costs to sell and its value in use.

Investment property comprises freehold and long leasehold land and buildings that are held either to earn rental income or for capital accretion or both. In accordance with the guidance published by the Royal Institution of Chartered Surveyors, investment property is carried at fair value based on current prices for similar properties, adjusted for the specific characteristics of the property (such as location or condition). If this information is not available, the Group uses alternative valuation methods such as discounted cash flow projections or recent prices in less active markets. These valuations are reviewed at least annually by independent professionally qualified valuers. Investment property being redeveloped for continuing use as investment property, or for which the market has become less active, continues to be valued at fair value.

(J) Leases
Under IFRS 16, a lessor is required to determine whether a lease is a finance or operating lease. A lessee is not required to make this determination.

(1) As lessor
Assets leased to customers are classified as finance leases if the lease agreements transfer substantially all the risks and rewards of ownership to the lessee but not necessarily legal title. All other leases are classified as operating leases. When assets are subject to finance leases, the present value of the lease payments, together with any unguaranteed residual value, is recognised as a receivable, net of allowances for expected credit losses and residual value impairment, within loans and advances to banks and customers. The difference between the gross receivable and the present value of the receivable is recognised as unearned finance lease income. Finance lease income is recognised in interest income over the term of the lease using the net investment method (before tax) so as to give a constant rate of return on the net investment in the leases. Unguaranteed residual values are reviewed regularly to identify any impairment.

Operating lease assets are included within property, plant and equipment at cost and depreciated over their estimated useful lives, which equates to the lives of the leases, after taking into account anticipated residual values. Operating lease rental income is recognised on a straight-line basis over the life of the lease.

The Group evaluates non-lease arrangements such as outsourcing and similar contracts to determine if they contain a lease which is then accounted for separately.

(2) As lessee
Leases are recognised as a right-of-use asset and a corresponding liability at the date at which the leased asset is available for use by the Group. Assets and liabilities arising from a lease are initially measured on a present value basis. The lease payments are discounted using the interest rate implicit in the lease, if that rate can be determined, or the Group's incremental borrowing rate appropriate for the right-of-use asset arising from the lease.

2 Accounting policies (continued)

Lease payments are allocated between the liability and finance cost. The finance cost is charged to profit or loss over the lease period so as to produce a constant periodic rate of interest on the remaining balance of the liability for each period. The right-of-use asset is depreciated over the shorter of the asset's useful life and the lease term on a straight-line basis.

Payments associated with short-term leases and leases of low-value assets are recognised on a straight-line basis as an expense in profit or loss. Short-term leases are leases with a lease term of twelve months or less. Low-value assets comprise IT equipment and small items of office furniture.

(K) Employee benefits
Short-term employee benefits, such as salaries, paid absences, performance-based cash awards and social security costs are recognised over the period in which the employees provide the related services.

Share-based compensation
Lloyds Banking Group operates a number of equity-settled, share-based compensation plans in respect of services received from certain of its employees. The value of the employee services received in exchange for equity instruments granted under these plans is recognised as an expense over the vesting period of the instruments, with a corresponding increase in equity. This expense is determined by reference to the fair value of the number of equity instruments that are expected to vest. The fair value of equity instruments granted is based on market prices, if available, at the date of grant. In the absence of market prices, the fair value of the instruments at the date of grant is estimated using an appropriate valuation technique, such as a Black-Scholes option pricing model or a Monte Carlo simulation. The determination of fair values excludes the impact of any non-market vesting conditions, which are included in the assumptions used to estimate the number of options that are expected to vest. At each balance sheet date, this estimate is reassessed and if necessary revised. Any revision of the original estimate is recognised in the income statement, together with a corresponding adjustment to equity. Cancellations by employees of contributions to the Group's Save As You Earn plans are treated as non-vesting conditions and the Group recognises, in the year of cancellation, the amount of the expense that would have otherwise been recognised over the remainder of the vesting period. Modifications are assessed at the date of modification and any incremental charges are charged to the income statement.

(L) Taxation
Tax expense comprises current and deferred tax. Current and deferred tax are charged or credited in the income statement except to the extent that the tax arises from a transaction or event which is recognised, in the same or a different period, outside the income statement (either in other comprehensive income, directly in equity, or through a business combination), in which case the tax appears in the same statement as the transaction that gave rise to it. The tax consequences of the Group's dividend payments (including distributions on other equity instruments), if any, are charged or credited to the statement in which the profit distributed originally arose.

Current tax is the amount of corporate income taxes expected to be payable or recoverable based on the profit for the period as adjusted for items that are not taxable or not deductible, and is calculated using tax rates and laws that were enacted or substantively enacted at the balance sheet date.

Current tax includes amounts provided in respect of uncertain tax positions when management expects that, upon examination of the uncertainty by Her Majesty's Revenue and Customs (HMRC) or other relevant tax authority, it is more likely than not that an economic outflow will occur. Provisions reflect management's best estimate of the ultimate liability based on their interpretation of tax law, precedent and guidance, informed by external tax advice as necessary. Changes in facts and circumstances underlying these provisions are reassessed at each balance sheet date, and the provisions are remeasured as required to reflect current information.

Deferred tax is recognised on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the balance sheet. Deferred tax is calculated using tax rates and laws that have been enacted or substantively enacted at the balance sheet date, and which are expected to apply when the related deferred tax asset is realised or the deferred tax liability is settled.

Deferred tax liabilities are generally recognised for all taxable temporary differences but not recognised for taxable temporary differences arising on investments in subsidiaries where the reversal of the temporary difference can be controlled and it is probable that the difference will not reverse in the foreseeable future. Deferred tax liabilities are not recognised on temporary differences that arise from goodwill which is not deductible for tax purposes.

Deferred tax assets are recognised to the extent it is probable that taxable profits will be available against which the deductible temporary differences can be utilised, and are reviewed at each balance sheet date and reduced to the extent that it is no longer probable that sufficient taxable profits will be available to allow all or part of the asset to be recovered.

Deferred tax assets and liabilities are not recognised in respect of temporary differences that arise on initial recognition of assets and liabilities acquired other than in a business combination. Deferred tax is not discounted.

(M) Foreign currency translation
Items included in the financial statements of each of the Group's entities are measured using the currency of the primary economic environment in which the entity operates (the functional currency). Foreign currency transactions are translated into the appropriate functional currency using the exchange rates prevailing at the dates of the transactions. Foreign exchange gains and losses resulting from the settlement of such transactions and from the translation at year end exchange rates of monetary assets and liabilities denominated in foreign currencies are recognised in the income statement, except when recognised in other comprehensive income as qualifying cash flow hedges. Non-monetary assets that are measured at fair value are translated using the exchange rate at the date that the fair value was determined. Translation differences on non-monetary items held at fair value through profit and loss are recognised in profit or loss as part of the fair value gain or loss. Translation differences on non-monetary financial assets measured at fair value through other comprehensive income are included in the fair value reserve in equity unless the asset is a hedged item in a fair value hedge.

2 Accounting policies (continued)

The results and financial position of all Group entities that have a functional currency different from the presentation currency are translated into the presentation currency as follows: the assets and liabilities of foreign operations are translated into sterling at foreign exchange rates ruling at the balance sheet date; and the income and expenses of foreign operations are translated into sterling at average exchange rates unless these do not approximate to the foreign exchange rates ruling at the dates of the transactions in which case income and expenses are translated at the dates of the transactions.

Foreign exchange differences arising on the translation of a foreign operation are recognised in other comprehensive income and accumulated in a separate component of equity together with exchange differences arising from the translation of borrowings and other currency instruments designated as hedges of such investments (see (F)(3) above). On disposal or liquidation of a foreign operation, the cumulative amount of exchange differences relating to that foreign operation are reclassified from equity and included in determining the profit or loss arising on disposal or liquidation.

(N) Provisions and contingent liabilities

Provisions are recognised in respect of present obligations arising from past events where it is probable that outflows of resources will be required to settle the obligations and they can be reliably estimated.

Contingent liabilities are possible obligations whose existence depends on the outcome of uncertain future events or those present obligations where the outflows of resources are uncertain or cannot be measured reliably. Contingent liabilities are not recognised in the financial statements but are disclosed unless they are remote.

Provision is made for expected credit losses in respect of irrevocable undrawn loan commitments and financial guarantee contracts (see (H) above).

(O) Share capital

Incremental costs directly attributable to the issue of new shares or options or to the acquisition of a business are shown in equity as a deduction, net of tax, from the proceeds. Dividends paid on the Group's ordinary shares are recognised as a reduction in equity in the period in which they are paid.

(P) Cash and cash equivalents

For the purposes of the cash flow statement, cash and cash equivalents comprise cash and non-mandatory balances with central banks and amounts due from banks with a maturity of less than three months.

(Q) Investment in subsidiaries

Investments in subsidiaries are carried at historical cost, less any provisions for impairment.

---

3 Critical accounting judgements and estimates

The preparation of the Group's financial statements in accordance with IFRS requires management to make judgements, estimates and assumptions in applying the accounting policies that affect the reported amounts of assets, liabilities, income and expenses. Due to the inherent uncertainty in making estimates, actual results reported in future periods may be based upon amounts which differ from those estimates. Estimates, judgements and assumptions are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances.

The significant judgements made by management in applying the Group's accounting policies and the key sources of estimation uncertainty in these financial statements, which together are deemed critical to the Group's results and financial position, are as follows:

Allowance for expected credit losses

Key judgements:	Determining an appropriate definition of default against which a probability of default, exposure at default and loss given default parameter can be evaluated The appropriate lifetime of an exposure to credit risk for the assessment of lifetime losses, notably on revolving products Establishing the criteria for a significant increase in credit risk The use of management judgement alongside impairment modelling processes to adjust inputs, parameters and outputs to reflect risks not captured by models
Key estimates:	Base case and Multiple Economic Scenarios (MES) assumptions, including the rate of unemployment and the rate of change of house prices, required for creation of MES scenarios and forward looking credit parameters

These judgements and estimates are subject to significant uncertainty.

The Group recognises an allowance for expected credit losses for loans and advances to customers and banks, other financial assets held at amortised cost, financial assets measured at fair value through other comprehensive income and certain loan commitment and financial guarantee contracts. At 31 December 2020 the Group's expected credit loss allowance was £3,331 million (2019: £2,148 million), of which £3,202 million (2019: £2,093 million) was in respect of drawn balances; and the Bank's expected credit loss allowance was £3,262 million (2019: £2,108 million), of which £3,133 million (2019: £2,053 million) was in respect of drawn balances.

The calculation of the Group's expected credit loss (ECL) allowances and provisions against loan commitments and guarantees under IFRS 9 requires the Group to make a number of judgements, assumptions and estimates. The most significant are set out below.

Definition of default

The probability of default (PD) of an exposure, both over a 12 month period and over its lifetime, is a key input to the measurement of the ECL allowance. Default has occurred when there is evidence that the customer is experiencing significant financial difficulty which is likely to affect the ability to repay amounts due. The definition of default adopted by the Group is described in note 2(H) Impairment of financial assets. The Group has rebutted the presumption in IFRS 9 that default occurs no later than when a payment is 90 days past due for UK mortgages. As a result, at 31 December 2020, approximately £1.0 billion of UK mortgages (2019: £1.2 billion) were classified as Stage 2 rather than Stage 3; the impact on the Group's ECL allowance was not material.

Lifetime of an exposure

A range of approaches, segmented by product type, has been adopted by the Group to estimate a product's expected life. These include using the full contractual life and taking into account behavioural factors such as early repayments and refinancing. For non-revolving retail assets, the Group has assumed the expected

3 Critical accounting judgements and estimates (continued)

life for each product to be the time taken for all significant losses to be observed. For retail revolving products, the Group has considered the losses beyond the contractual term over which the Group is exposed to credit risk. For commercial overdraft facilities, the average behavioural life has been used. Changes to the assumed expected lives of the Group's assets could impact the ECL allowance recognised by the Group. The assessment of SICR and corresponding lifetime loss, and the PD, of a financial asset deemed to be Stage 2, or Stage 3, is dependent on its expected life.

Significant increase in credit risk

Performing assets are classified as either Stage 1 or Stage 2. An ECL allowance equivalent to 12 months expected losses is established against assets in Stage 1; assets classified as Stage 2 carry an ECL allowance equivalent to lifetime expected losses. Assets are transferred from Stage 1 to Stage 2 when there has been a significant increase in credit risk (SICR) since initial recognition. Credit impaired assets are transferred to Stage 3 with a lifetime expected losses allowance. The Group uses both quantitative and qualitative indicators to determine whether there has been a SICR for an asset. For Retail, the following tables set out the Retail Master Scale (RMS) grade triggers which result in a SICR for financial assets and the PD boundaries for each RMS grade. Credit cards SICR triggers have been refined in 2020 following a review of sensitivity to changes in economic assumptions, 2019 triggers were previously aligned to Loans and overdrafts. The impact of this has been approximately £436 million of additional assets being classified as Stage 2 at 31 December 2020, with a corresponding increase in the ECL of £15 million resulting from the transfer to a lifetime expected loss.

SICR Triggers for key Retail portfolios

Origination grade	**1**	**2**	**3**	**4**	**5**	**6**	**7**
Mortgages SICR grade	5	5	6	7	8	9	10
Credit cards SICR grade	4	5	6	7	8	9	10
Loans and overdrafts SICR grade	5	6	7	8	9	10	11

RMS grade	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**11**	**12**	**13**	**14**
PD boundary %	0.10	0.40	0.80	1.20	2.50	4.50	7.50	10.00	14.00	20.00	30.00	45.00	99.99	100.00

For Commercial a doubling of PD with a minimum increase in PD of 1 per cent and a resulting change in the underlying grade is treated as a SICR.

The Group uses the internal credit risk classification and watchlist as qualitative indicators to identify a SICR. The Group does not use the low credit risk exemption in its staging assessments. The use of a payment holiday in and of itself has not been judged to indicate a significant increase in credit risk, nor forbearance, with the underlying long-term credit risk deemed to be driven by economic conditions and captured through the use of forward-looking models. These portfolio level models are capturing the anticipated volume of increased defaults and therefore an appropriate assessment of staging and expected credit loss.

All financial assets are assumed to have suffered a SICR if they are more than 30 days past due; non-mortgage Retail financial assets are also assumed to have suffered a SICR if they are in arrears on three or more separate occasions in a rolling twelve month period. Financial assets are classified as credit impaired if they are 90 days past due except for UK mortgages where a 180 days backstop is used.

A Stage 3 asset that is no longer credit-impaired is transferred back to Stage 2 as no cure period is applied to Stage 3. If an exposure that is classified as Stage 2 no longer meets the SICR criteria, which in some cases include a minimum cure period, it is moved back to Stage 1.

The setting of precise trigger points combined with risk indicators requires judgement. The use of different trigger points may have a material impact upon the size of the ECL allowance. The Group monitors the effectiveness of SICR criteria on an ongoing basis.

Generation of Multiple Economic Scenarios (MES)

The measurement of expected credit losses is required to reflect an unbiased probability-weighted range of possible future outcomes. The Group considers the choice of approach used to generate the range of economic outcomes to be judgemental, given several methods can be adopted. In addition to a defined base case, as used for planning, the Group's approach relies on model-generated scenarios, reducing scope for bias in the selection of scenarios and their weightings. The conditioning assumptions underpinning the base case scenario reflect the Group's best view of future events. Where outcomes materially diverge from the conditioning assumptions adopted, the base case scenario is updated. The base case is therefore central to the range of outcomes created as no alternative conditioning assumptions are factored into the model-generated scenarios.

The Group models a full distribution of economic scenarios around this base case, ranking them using estimated relationships with industry-wide historical loss data. The full distribution is summarised by a practical number of scenarios to run through ECL models representing four sections: an upside, the base case, and a downside scenario weighted at 30 per cent each, with a severe downside scenario weighted at 10 per cent. With the base case already pre-defined, the other three scenarios are constructed as averages of constituent modelled scenarios around the 15th, 75th and 95th percentiles of the distribution. The scenario weights therefore represent the allocation to each summary segment of the distribution and not a subjective view on likelihood. The inclusion of a severe downside scenario with a smaller weighting but relatively large credit losses, ensures the non-linearity of losses in the tail of the distribution is captured when ECL based on the weighted result of the four scenarios is calculated.

A committee under the chairmanship of the Lloyds Banking Group's Chief Economist meets at least quarterly to review and, if appropriate, recommend changes to the method by which economic scenarios are generated; for approval by the Lloyds Banking Group's Chief Financial Officer and Lloyds Banking Group's Chief Risk Officer. In 2020, a change was made to the way in which the distribution of scenarios is created. This change allows for a greater dispersal of economic outcomes in the early periods of the forecast, to recognise the increased near-term profile of risks present since the onset of the coronavirus pandemic. This change allows for a wider distribution of losses both on the upside and downside, although is most evident in the severe downside scenario, given it represents a more adverse segment of the distribution.

Base Case and MES Economic Assumptions

The Group's base case economic scenario has continued to be revised in light of the impact of the coronavirus pandemic in the UK and globally. The scenario reflects judgements of the net effect of government-mandated restrictions on economic activity, large-scale government interventions, and behavioural changes by households and businesses that may persist beyond the rollout of coronavirus vaccination programmes.

3 Critical accounting judgements and estimates (continued)

Despite large-scale vaccination efforts commencing in the UK and globally, there remains considerable uncertainty about the pace and eventual extent of the post-pandemic recovery. The Group's current base case scenario builds in three key conditioning assumptions. First, the UK vaccine rollout successfully protects the elderly, key workers and the clinically vulnerable by mid-2021. Second, national lockdowns end by April 2021, allowing a phased return to a tiered system of restrictions that are progressively eased in the second quarter and second half of 2021, leaving only limited restrictions in place by the end of 2021. Third, government policy measures including specifically the furlough scheme continue to provide support for the duration of severe economic restrictions, through to mid-2021.

Conditioned on the above assumptions and despite the recovery in economic activity resuming from the second quarter of 2021, the Group's base case outlook assumes a rise in the unemployment rate and weakness in residential and commercial property prices. Risks around this base case economic view lie in both directions and are partly captured by the MES generated. But uncertainties relating to the key conditioning assumptions, including epidemiological developments and the efficacy of vaccine rollouts, are not specifically captured by the MES scenarios. These specific risks have been recognised outside the modelled scenarios published below.

The Group has accommodated the latest available information at the reporting date in defining its base case scenario and generating the MES. The scenarios include forecasts for key variables in the fourth quarter of 2020, for which actuals may have since emerged prior to publication.

Base case scenario by quarter[1]

Base case	First quarter 2020 %	Second quarter 2020 %	Third quarter 2020 %	Fourth quarter 2020 %	First quarter 2021 %	Second quarter 2021 %	Third quarter 2021 %	Fourth quarter 2021 %
Gross domestic product	(3.0)	(18.8)	16.0	(1.9)	(3.8)	5.6	3.6	1.5
UK Bank Rate	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
Unemployment rate	4.0	4.1	4.8	5.0	5.2	6.5	8.0	7.5
House price growth	2.8	2.6	7.2	5.9	5.5	4.7	(1.6)	(3.8)
Commercial real estate price growth	(5.0)	(7.8)	(7.8)	(7.0)	(6.1)	(2.9)	(2.2)	(1.7)

1 Gross domestic product presented quarter on quarter, house price growth and commercial real estate growth presented year on year - i.e. from the equivalent quarter the previous year. Bank Rate is presented end quarter.

Scenarios by year

Key annual assumptions made by the Group are shown below. Gross domestic product is presented as an annual change, house price growth and commercial real estate price growth are presented as the growth in the respective indices within the period. UK Bank Rate and unemployment rate are averages for the period.

	2020 %	2021 %	2022 %	2023 %	2024 %
Upside					
Gross domestic product	(10.5)	3.7	5.7	1.7	1.5
UK Bank Rate	0.10	1.14	1.27	1.20	1.21
Unemployment rate	4.3	5.4	5.4	5.0	4.5
House price growth	6.3	(1.4)	5.2	6.0	5.0
Commercial real estate price growth	(4.6)	9.3	3.9	2.1	0.3
Base case					
Gross domestic product	(10.5)	3.0	6.0	1.7	1.4
UK Bank Rate	0.10	0.10	0.10	0.21	0.25
Unemployment rate	4.5	6.8	6.8	6.1	5.5
House price growth	5.9	(3.8)	0.5	1.5	1.5
Commercial real estate price growth	(7.0)	(1.7)	1.6	1.1	0.6
Downside					
Gross domestic product	(10.6)	1.7	5.1	1.4	1.4
UK Bank Rate	0.10	0.06	0.02	0.02	0.03
Unemployment rate	4.6	7.9	8.4	7.8	7.0
House price growth	5.6	(8.4)	(6.5)	(4.7)	(3.0)
Commercial real estate price growth	(8.7)	(10.6)	(3.2)	(0.8)	(0.8)
Severe downside					
Gross domestic product	(10.8)	0.3	4.8	1.3	1.2
UK Bank Rate	0.10	0.00	0.00	0.01	0.01
Unemployment rate	4.8	9.9	10.7	9.8	8.7
House price growth	5.3	(11.1)	(12.5)	(10.7)	(7.6)
Commercial real estate price growth	(11.0)	(21.4)	(9.8)	(3.9)	(0.8)

3 Critical accounting judgements and estimates (continued)

Economic assumptions - five year average

The key UK economic assumptions made by the Group averaged over a five-year period are shown below. The five-year period reflects movements within the current reporting year such that 31 December 2020 reflects five years 2020 to 2024. The prior year comparative data has been re-presented to align to the equivalent period, 2019 to 2023. The inclusion of the reporting year within the five-year period reflects the need to predict variables which remain unpublished at the reporting date, and recognises that credit models utilise both level and annual change in calculating ECL. The use of calendar years also maintains a comparability between tables disclosed.

	At 31 December 2020				At 31 December 2019			
	Upside %	**Base case %**	**Downside %**	**Severe downside %**	Upside %	Base case %	Downside %	Severe downside %
Gross domestic product	**0.3**	**0.1**	**(0.4)**	**(0.8)**	1.6	1.3	1.0	0.3
UK Bank Rate	**0.98**	**0.15**	**0.05**	**0.02**	1.87	1.15	0.51	0.17
Unemployment rate	**5.0**	**5.9**	**7.1**	**8.8**	3.9	4.3	5.5	6.7
House price growth	**4.2**	**1.1**	**(3.5)**	**(7.5)**	5.1	1.4	(2.5)	(7.0)
Commercial real estate price growth	**2.1**	**(1.1)**	**(4.9)**	**(9.7)**	1.6	(0.3)	(3.9)	(7.3)

	At 31 December 2020				At 31 December 2019			
Economic assumptions – start to peak	**Upside %**	**Base case %**	**Downside %**	**Severe downside %**	Upside %	Base case %	Downside %	Severe downside %
Gross domestic product	**1.4**	**0.8**	**(1.7)**	**(3.0)**	8.4	6.6	5.5	1.8
UK Bank Rate	**1.44**	**0.25**	**0.10**	**0.10**	2.56	1.75	0.75	0.75
Unemployment rate	**6.5**	**8.0**	**9.3**	**11.5**	4.4	4.6	6.9	8.3
House price growth	**22.6**	**5.9**	**5.6**	**5.3**	28.3	7.1	2.7	2.7
Commercial real estate price growth	**11.0**	**(2.7)**	**(2.7)**	**(2.7)**	8.8	(0.8)	(0.8)	(0.8)

	At 31 December 2020				At 31 December 2019			
Economic assumptions – start to trough	**Upside %**	**Base case %**	**Downside %**	**Severe downside %**	Upside %	Base case %	Downside %	Severe downside %
Gross domestic product	**(21.2)**	**(21.2)**	**(21.2)**	**(21.2)**	0.3	0.3	0.3	(2.4)
UK Bank Rate	**0.10**	**0.10**	**0.01**	**0.00**	0.75	0.75	0.35	0.01
Unemployment rate	**4.0**	**4.0**	**4.0**	**4.0**	3.4	3.8	3.8	3.8
House price growth	**(0.5)**	**(0.5)**	**(16.4)**	**(32.4)**	1.5	0.0	(12.0)	(30.3)
Commercial real estate price growth	**(6.9)**	**(9.0)**	**(22.2)**	**(39.9)**	(1.4)	(2.3)	(17.9)	(31.4)

The table below shows the Group's ECL for the upside and downside scenarios using a 100 per cent weighting, with stage allocation based on each specific scenario.

	At 31 December 2020	
	Upside £m	**Downside £m**
ECL allowance	**2,768**	**3,651**

Individual assessments

Stage 3 ECL in Commercial Banking is largely assessed on an individual basis using bespoke assessment of loss for each specific client. These assessments are carried out by the Business Support Unit based on detailed reviews and expected recovery strategies. While these assessments are based on the Group's latest economic view, the use of group-wide multiple economic scenarios and weightings is not considered appropriate for these cases due to their individual characteristics. In place of this a range of case specific outcomes are considered with any alternative better or worse outcomes that carry a 25 per cent likelihood taken into account in establishing a probability-weighted ECL.

Application of judgement in adjustments to modelled ECL

Impairment models fall within the Group's Model Risk framework with model monitoring, periodic validation and back testing performed on model components (i.e. probability of default, exposure at default and loss given default). Limitations in the Group's impairment models or data inputs, may be identified through the ongoing assessment and validation of the output of the models. In these circumstances, management make appropriate adjustments to the Group's allowance for impairment losses to ensure that the overall provision adequately reflects all material risks. These adjustments are determined by considering the particular attributes of exposures which have not been adequately captured by the impairment models and range from changes to model inputs and parameters, at account level, through to more qualitative post-model overlays.

Judgements are not typically assessed under each distinct economic scenario used to generate ECL, but instead are applied on the basis of final modelled ECL which reflects the probability weighted view of all scenarios. All adjustments are reviewed quarterly and are subject to internal review and challenge, including by the Audit Committee, to ensure that amounts are appropriately calculated and that there are specific release criteria within a reasonable timeframe.

3 Critical accounting judgements and estimates (continued)

At 31 December 2020 the coronavirus pandemic and the various support measures that have been put in place have resulted in an economic environment which differs significantly from the historical economic conditions upon which the impairment models have been built. As a result there is a greater need for management judgements to be applied alongside the use of models. At 31 December 2020 management judgement resulted in additional ECL allowances. This comprises judgements added due to COVID-19 in the year and other judgements not directly linked to COVID-19 but which have increased in size under the current outlook.

Management Judgements in respect of COVID-19

Recognition of impact of support measures in Retail: £109 million

The use of payment holidays along with subdued levels of consumer spending is judged to have temporarily reduced the flow of accounts into arrears and default and to have also improved average credit scores across portfolios. Management believes that the resulting position does not fully reflect the underlying credit risk in the portfolios. Adjustments have therefore been made to increase expected future rates of default and remove the impact of the observed improvement in average credit scores. An adjustment has also been made to reflect an increase in the time assumed between default and repossession as a result of the Group temporarily suspending the repossession of properties to support customers during the pandemic.

Central Overlay in respect of economic uncertainty: £200 million

An important element of the methodology used to calculate the Group's ECL allowance is the determination of a base case economic scenario, predicated on certain conditioning assumptions, from which alternative scenarios are derived using stochastic shocks. The rapid evolution of the pandemic and significant changes that this has brought about could continue into 2021 and may partially invalidate the conditioning assumptions that underpin the Group's base case scenario. Management believes that the risks to the conditioning assumptions around the base case scenario are markedly to the downside, reflecting notably the potential for a material delay in the vaccination programme or reduction in its effectiveness from further virus mutation and the corresponding delayed withdrawal of restrictions on social interaction or introduction of further lockdowns. The Group's ECL allowances are required to reflect an unbiased probability-weighted view of all possible future outcomes and therefore management believes that an adjustment is required to capture these additional risks.

An adjustment of £200 million has been made to increase the Group's ECL allowances to reflect this increased uncertainty around the conditioning assumptions. This equates to a 1 percentage point increase in unemployment allied with a 5 per cent lower HPI in 2021, reflecting a more immediate and therefore greater ECL impact than the gradual increase reflected in the stated univariate sensitivity. It is proportionate to the level of volatility seen in forecasts as the pandemic has unfolded and is also equivalent to a 10 per cent re-weighting from the upside to the severe downside scenario. The adjustment, which has not been allocated to a specific portfolio, has been allocated against Stage 1 assets given the downside risks are largely considered to relate to exposures with currently low default probabilities, the majority of which are in Stage 1. Through 2021 the scale of the uncertainty is expected to diminish and the need for this adjustment will then be reassessed.

Other Management judgements

Adjustment to modelled forecast parameters: £277 million (2019: £nil)

Adjustments have been required to the estimated defaults used within the ECL calculation for UK mortgages following the adoption of new default forecast models. Forecast models which predict quarterly defaults based on several economic variables have been developed using the response from the previous recession, as per usual modelling best practice. However, management believe further adjustments are necessary when the results of these models have been benchmarked to observed levels, given the atypical nature of the current economic outlook. These were derived using historical observed default rates under previous downturn conditions to ensure that the resulting forecast best reflected management's view given the current economic outlook. The adjustment to forward looking parameters prior to their use in ECL calculations ensures that all downstream account level calculations reflect the Group's best view of credit losses in respect of the economic scenarios stated. As such this in-model adjustment is reflected within all scenarios, assessment of staging and in subsequent assessment of all post-model adjustments.

End-of-term interest only: £225 million (2019: £205 million)

The current definition of default used in the UK mortgages impairment model excludes past term interest only accounts that continue to make interest payments but have missed their capital payment upon maturity of the loan. This adjustment therefore mitigates the risk that the model understates the credit losses associated with interest-only accounts which have missed, or will potentially miss, their final capital payment. For those accounts that have reached end of term this adjustment manually overwrites PDs to 70 per cent or 100 per cent, thereby moving them into Stage 2, or Stage 3, depending on whether they are deemed performing, or non-performing respectively. For interest-only accounts with six years or less to maturity an appropriate incremental PD uplift is made to PDs based on the probability of missing a future capital payment, assessed through segmentation of behaviour score, debt-to-value and worst ever arrears status. The increase in the judgement in 2020 is primarily driven by an increase in the stock of long-term defaults following COVID-19 related litigation suspension.

Long-term defaults: £145 million (2019: £80 million)

The Group suspended mortgage litigation activity between late 2014 and mid 2018 as changes were implemented to the treatment of amounts in arrears, interrupting the natural flow of accounts to possession. An adjustment is made to ensure adequate provision coverage considering the resulting build-up of accounts in long-term default. Coverage is uplifted to the equivalent levels of those accounts already in repossession on an estimated shortfall of balances expected to flow to possession. A further adjustment is made to mitigate for the risk that credit model provision understates the probability of possession for accounts which have been in default for more than 24 months, with an arrears balance increase in the last 6 months. These accounts have their probability of possession set to 95 per cent based on observed historical losses incurred on accounts that were of an equivalent status. The increase in judgement in 2020 is primarily driven by an increase in the stock of long-term defaults following COVID-19 related litigation suspension.

Recoverability of deferred tax assets and uncertain tax positions

Key judgements: Assessing the likely level of future taxable profits taking into account the Group's long-term financial and strategic plans
Interpreting tax rules on the Group's open tax matters

At 31 December 2020 the Group carried deferred tax assets on its balance sheet of £1,721 million (2019: £1,652 million) and the Bank carried deferred tax assets of £1,718 million (2019: £1,647 million) principally relating to tax losses carried forward. Further information on the Group's deferred tax assets and uncertain tax positions is provided in notes 27 and 37 respectively.

Estimation of income taxes includes the assessment of recoverability of deferred tax assets. Deferred tax assets are only recognised to the extent that they are considered more likely than not to be recoverable based on existing tax laws and forecasts of future taxable profits against which the underlying tax deductions can be utilised. The Group has recognised a deferred tax asset of £1,547 million (2019: £1,402 million), and the Bank £1,525 million (2019: £1,382 million) in respect of trading losses carried forward. Substantially all of these losses have arisen in Bank of Scotland plc and they will be utilised as taxable profits arise in this legal entity in future periods.

The Group's expectations of future UK taxable profits require management judgement, and take into account the Group's long-term financial and strategic plans and anticipated future tax-adjusting items. In making this assessment, account is taken of business plans, the Board-approved operating plan and the expected future economic outlook as set out in the strategic report, as well as the risks associated with future regulatory change, in order to produce a base case forecast of future UK taxable profits. Under current law there is no expiry date for UK trading losses not yet utilised, and given the forecast of future profitability and the Group's commitment to the UK market, it is more likely than not the value of the losses will be recovered at some point in the future. Banking tax losses that arose before 1 April 2015 can only be used against 25 per cent of taxable profits arising after 1 April 2016, and they cannot be used to reduce the surcharge on banking profits. These restrictions in utilisation mean that the value of the deferred tax asset in respect of tax losses is only expected to be fully recovered by 2034 (2019: 2033) in the base case forecast. It is possible that future tax law changes could materially affect the timing of recovery and the value of these losses ultimately realised by the Group. The value of the deferred tax asset in respect of tax losses increased by £160 million in 2020 as a result of the change in UK tax rates (see note 27).

As disclosed in note 37, the Lloyds Banking Group has an open matter in relation to a claim for group relief of losses incurred in its former Irish banking subsidiary, where the final tax position will remain uncertain until the matter is finally determined by judicial process.

Regulatory provisions

Key judgements: Determining the scope of reviews required by regulators
The impact of legal decisions that may be relevant to claims received

Key estimates: The number of future complaints
The proportion of complaints that will be upheld
The average cost of redress

At 31 December 2020, the Group carried provisions of £230 million (2019: £828 million) and the Bank £229 million (2019: £819 million) against the cost of making redress payments to customers and the related administration costs in connection with historical regulatory breaches.

Determining the amount of the provisions, which represent management's best estimate of the cost of settling these issues, requires the exercise of significant judgement and estimation. It will often be necessary to form a view on matters which are inherently uncertain, such as the scope of reviews required by regulators, and to estimate the number of future complaints, the extent to which they will be upheld, the average cost of redress and the impact of decisions reached by legal and other review processes that may be relevant to claims received. Consequently the continued appropriateness of the underlying assumptions is reviewed on a regular basis against actual experience and other relevant evidence and adjustments made to the provisions where appropriate.

4 Segmental analysis

IFRS 8 'Operating Segments' requires reporting of financial and descriptive information about operating segments which are based on how financial information is reported and evaluated internally. The chief operating decision maker has been identified as the Group Executive Committee of Lloyds Banking Group. The Bank of Scotland Group is managed on an entity basis and not by segment. The Group Executive Committee does not assess the Bank of Scotland Group's performance and allocate resources across any segments, accordingly no segmental information is provided. A brief overview of the Group's sources of income is provided in the Business review. The ultimate parent undertaking, Lloyds Banking Group plc, produces consolidated accounts which set out the basis of the segments through which it manages performance and allocates resources across the consolidated Lloyds Banking Group.

5 Net interest income

	Weighted average effective interest rate			
The Group	**2020 %**	2019 %	**2020 £m**	2019 £m
Interest income:				
Financial assets held at amortised cost	**2.13**	2.53	**7,539**	8,633
Financial assets at fair value through other comprehensive income	**0.97**	1.34	**26**	26
Total interest income[1]	**2.13**	2.52	**7,565**	8,659
Interest expense:				
Deposits from banks, customer deposits and other liabilities	**0.76**	1.03	**(2,243)**	(2,998)
Debt securities in issue[2]	**(0.48)**	0.31	**44**	(34)
Subordinated liabilities	**2.29**	2.84	**(142)**	(181)
Lease liabilities	**2.19**	2.48	**(16)**	(18)
Total interest expense	**0.76**	1.04	**(2,357)**	(3,231)
Net interest income			**5,208**	5,428

1 Includes £8 million (2019: £12 million) in respect of interest income on finance leases.

2 The impact of the Group's hedging arrangements is included on this line; excluding this impact the weighted average effective interest rate in respect of debt securities in issue would be 2.58 per cent (2019: 2.97 per cent).

Included within interest income is £105 million (2019: £129 million) in respect of credit-impaired financial assets. Net interest income also includes a credit of £4 million (2019: debit of £37 million) transferred from the cash flow hedging reserve (see note 31).

6 Net fee and commission income

The Group	2020 £m	2019 £m
Fee and commission income:		
Current accounts	**203**	214
Credit and debit card fees	**206**	249
Other	**59**	138
Total fee and commission income	**468**	601
Fee and commission expense	**(269)**	(281)
Net fee and commission income	**199**	320

Fees and commissions which are an integral part of the effective interest rate form part of net interest income shown in note 5. Fees and commissions relating to instruments that are held at fair value through profit or loss are included within net trading income shown in note 7.

At 31 December 2020, the Group held on its balance sheet £22 million (31 December 2019: £34 million) in respect of services provided to customers. There were no unsatisfied performance obligations at 31 December 2019 or 31 December 2020.

The most significant performance obligations undertaken by the Group are in respect of current accounts, the provision of other banking services for commercial customers and credit and debit card services. In respect of current accounts, the Group receives fees for the provision of bank account and transaction services such as ATM services, fund transfers, overdraft facilities and other value-added offerings. For commercial customers, alongside its provision of current accounts, the Group provides other corporate banking services including factoring and commitments to provide loan financing. Loan commitment fees are included in fees and commissions where the loan is not expected to be drawn down by the customer. The Group receives interchange and merchant fees, together with fees for overseas use and cash advances, for provision of card services to cardholders and merchants.

7 Net trading (losses) income

The Group	2020 £m	2019 £m
Foreign exchange translation (losses) gains	**13**	(29)
Gains on foreign exchange trading transactions	**23**	36
Total foreign exchange	**36**	7
Investment property losses	**(20)**	(8)
Hedging and other losses (gains)	**(385)**	246
Net trading (losses) income	**(369)**	245

8 Other operating income

The Group	2020 £m	2019 £m
Operating lease rental income	**–**	1
Gains less losses on disposal of financial assets at fair value through other comprehensive income	**10**	–
Liability management	**(5)**	(37)
Gain on disposal of business	**45**	36
Other	**59**	40
Total other operating income	**109**	40

9 Operating expenses

The Group	2020 £m	2019 £m
Staff costs:		
Salaries	**887**	1,039
Social security costs	**81**	96
Pensions and other post-retirement benefit schemes	**194**	208
	1,162	1,343
Premises and equipment:		
Rent and rates	**63**	54
Repairs and maintenance	**37**	58
Other	**83**	96
	183	208
Other expenses:		
Communications and data processing	**118**	121
Advertising and promotion	**54**	51
Professional fees	**10**	15
Other	**776**	1,115
	958	1,302
Depreciation and amortisation:		
Depreciation of property, plant and equipment (note 20)	**199**	204
Amortisation of other intangible assets (note 19)	**33**	31
	232	235
Total operating expenses, excluding regulatory provisions	**2,535**	3,088
Regulatory provisions:		
Payment protection insurance provision (note 28)	**(77)**	963
Other regulatory provisions (note 28)	**184**	254
	107	1,217
Total operating expenses	**2,642**	4,305

The average number of staff on a headcount basis during the year was as follows[1]:

	2020	2019
UK	**26,869**	28,860
Overseas	**389**	378
Total	**27,258**	29,238

1 The majority of the Group's staff are contractually employed by the Bank's parent company, HBOS plc.

10 Auditor's remuneration

Fees payable to the Bank's auditors
During the year the auditors earned the following fees:

	2020 £m	2019 £m
Fees payable for the audit of the Bank's current year annual report	**3.5**	3.2
Fees payable for other services:		
Audit of the Bank's subsidiaries pursuant to legislation	**1.0**	0.6
Other services supplied pursuant to legislation	**0.4**	0.3
Total fees payable to the Bank's auditors by the Group	**4.9**	4.1

Audit fees payable in respect of the statutory audit of Group entities totalled £4.5 million (2019: £3.8 million) and non-audit-fees, as defined by the Financial Reporting Council's Ethical Guidance, totalled £0.4 million (2019: £0.3 million).

The following types of services are included in the categories listed above:

Audit fees: This category includes fees in respect of the audit of the Group's annual financial statements and other services in connection with regulatory filings. Other services supplied pursuant to legislation relate primarily to costs incurred in connection with client asset assurance and with the Sarbanes-Oxley Act requirements associated with the audit of the Lloyds Banking Group's financial statements filed on its Form 20-F.

10 Auditor's remuneration (continued)

Audit related fees: This category includes fees in respect of services for assurance and related services that are reasonably related to the performance of the audit or review of the financial statements, for example acting as reporting accountants in respect of debt prospectuses required by the listing rules. The auditors were not engaged to provide such services for the Bank.

Other non-audit fees: This category includes other assurance services not related to the performance of the audit or review of the financial statements, for example, the review of controls operated by the Group on behalf of a third party. The auditors were not engaged to provide such services for the Bank, including tax services.

It is the Group's policy to use the auditors on assignments in cases where their knowledge of the Group means that it is neither efficient nor cost effective to employ another firm of accountants.

The Group has procedures that are designed to ensure auditor independence, including prohibiting certain non-audit services. All audit and non-audit assignments must be pre-approved by the audit committee on an individual engagement basis; for certain types of non-audit engagements where the fee is 'de minimis' the audit committee has pre-approved all assignments subject to confirmation by management. On a quarterly basis, the audit committee receives and reviews a report detailing all pre-approved services and amounts paid to the auditors for such pre-approved services.

11 Impairment

The Group	Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m
Year ended 31 December 2020				
Impact of transfers between stages	**(49)**	**348**	**267**	**566**
Other changes in credit quality	**387**	**102**	**596**	**1,085**
Additions (repayments)	**31**	**(13)**	**(42)**	**(24)**
Other items	**–**	**–**	**(5)**	**(5)**
	418	**89**	**549**	**1,056**
Total impairment	**369**	**437**	**816**	**1,622**
In respect of:				
Loans and advances to customers	**339**	**396**	**812**	**1,547**
Due from fellow Lloyds Banking Group undertakings	**1**	**–**	**–**	**1**
Financial assets at amortised cost	**340**	**396**	**812**	**1,548**
Loan commitments and financial guarantees	**29**	**41**	**4**	**74**
Total impairment	**369**	**437**	**816**	**1,622**

The Group	Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m
Year ended 31 December 2019				
Impact of transfers between stages	(17)	51	161	195
Other changes in credit quality	(5)	(90)	457	362
Additions (repayments)	26	(49)	(81)	(104)
Other items	–	–	(3)	(3)
	21	(139)	373	255
Total impairment	4	(88)	534	450
In respect of:				
Loans and advances to customers	5	(93)	536	448
Due from fellow Lloyds Banking Group undertakings	(3)	–	–	(3)
Financial assets at amortised cost	2	(93)	536	445
Loan commitments and financial guarantees	2	5	(2)	5
Total impairment	4	(88)	534	450

The Group's impairment charge comprises the following items:

Transfers between stages
The net impact on the impairment charge of transfers between stages.

Other changes in credit quality
Changes in loss allowance as a result of movements in risk parameters that reflect changes in customer quality, but which have not resulted in a transfer to a different stage. This also contains the impact on the impairment charge as a result of write-offs and recoveries, where the related loss allowances are reassessed to reflect ultimate realisable or recoverable value.

11 Impairment (continued)

Additions (repayments)
Expected loss allowances are recognised on origination of new loans or further drawdowns of existing facilities. Repayments relate to the reduction of loss allowances as a result of repayments of outstanding balances.

Movements in the Group's impairment allowances are shown in note 15.

12 Tax expense

a Analysis of tax credit (expense) for the year

The Group	2020 £m	2019 £m
UK corporation tax:		
Current tax on profit for the year	(109)	(463)
Adjustments in respect of prior years	50	15
	(59)	(448)
Foreign tax:		
Current tax on profit for the year	12	(24)
Adjustments in respect of prior years	2	–
	14	(24)
Current tax expense	(45)	(472)
Deferred tax (note 27):		
Current year	109	(111)
Adjustments in respect of prior years	(34)	(21)
Deferred tax credit (expense)	75	(132)
Tax credit (expense)	30	(604)

b Factors affecting the tax expense for the year
The UK corporation tax rate for the year was 19 per cent (2019: 19 per cent). An explanation of the relationship between tax expense and accounting profit is set out below:

The Group	2020 £m	2019 £m
Profit before tax	883	1,278
UK corporation tax thereon	(168)	(243)
Impact of surcharge on banking profits	(59)	(165)
Non-deductible costs: conduct charges	13	(171)
Non-deductive costs: bank levy	(11)	–
Other non-deductible costs	(18)	(45)
Non-taxable income	39	13
Tax relief on coupons on other equity instruments	31	19
Remeasurement of deferred tax due to rate changes	182	(5)
Differences in overseas tax rates	3	(1)
Adjustments in respect of prior years	18	(6)
Tax credit (expense)	30	(604)

13 Financial assets at fair value through profit or loss

	The Group		The Bank	
	2020 £m	2019 £m	2020 £m	2019 £m
Loans and advances to customers mandatorily at fair value through profit or loss	477	463	158	117

At 31 December 2020 £477 million (2019: £463 million) of financial assets at fair value through profit or loss of the Group and £158 million (2019: £117 million) of the Bank had a contractual residual maturity of greater than one year.

14 Derivative financial instruments

The fair values and notional amounts of derivative instruments are set out in the following table:

	2020			2019		
The Group	**Contract/ notional amount £m**	**Fair value assets £m**	**Fair value liabilities £m**	Contract/ notional amount £m	Fair value assets £m	Fair value liabilities £m
Trading and other						
Exchange rate contracts:						
Spot, forwards and futures	**794**	**14**	**49**	2,690	65	15
Currency swaps	**32,733**	**630**	**697**	38,095	927	865
Options purchased	**2**	**–**	**–**	24	1	–
Options written	**2**	**–**	**–**	24	–	1
	33,531	**644**	**746**	40,833	993	881
Interest rate contracts:						
Interest rate swaps	**93,427**	**5,467**	**6,649**	170,525	7,800	9,173
Forward rate agreements	**2,940**	**–**	**–**	–	–	–
Options purchased	**135**	**12**	**–**	323	12	–
Options written	**250**	**–**	**1**	359	–	1
	96,752	**5,479**	**6,650**	171,207	7,812	9,174
Credit derivatives	**2,132**	**15**	**21**	1,588	6	17
Equity and other contracts	**47**	**–**	**257**	102	4	284
Total trading and other derivative assets/ liabilities	**132,462**	**6,138**	**7,674**	213,730	8,815	10,356
Hedging						
Derivatives designated as fair value hedges:						
Interest rate swaps	**4,235**	**533**	**106**	6,051	880	170
Derivatives designated as cash flow hedges:						
Interest rate swaps	**9,993**	**752**	**892**	13,227	643	826
Total hedging derivative assets/liabilities	**14,228**	**1,285**	**998**	19,278	1,523	996
Total recognised derivative assets/liabilities	**146,690**	**7,423**	**8,672**	233,008	10,338	11,352

The notional amount of the contract does not represent the Group's exposure to credit risk which is limited to the current cost of replacing contracts with a positive value to the Group should the counterparty default. To reduce credit risk the Group uses a variety of credit enhancement techniques such as netting and collateralisation, where security is provided against the exposure; a large proportion of the Group's derivatives are held through exchanges such as London Clearing House and are collateralised through those exchanges. Further details are provided in note 42 Credit risk.

The Group holds derivatives as part of the following strategies:

- Customer driven, where derivatives are held as part of the provision of risk management products to Group customers; and
- To manage and hedge the Group's interest rate and foreign exchange risk arising from normal banking business. The hedge accounting strategy adopted by the Group is to utilise a combination of fair value and cash flow hedge approaches as described in note 42.

The principal derivatives used by the Group are as follows:

- Interest rate related contracts include interest rate swaps, forward rate agreements and options. An interest rate swap is an agreement between two parties to exchange fixed and floating interest payments, based upon interest rates defined in the contract, without the exchange of the underlying principal amounts. Forward rate agreements are contracts for the payment of the difference between a specified rate of interest and a reference rate, applied to a notional principal amount at a specific date in the future. An interest rate option gives the buyer, on payment of a premium, the right, but not the obligation, to fix the rate of interest on a future loan or deposit, for a specified period and commencing on a specified future date.
- Exchange rate related contracts include forward foreign exchange contracts, currency swaps and options. A forward foreign exchange contract is an agreement to buy or sell a specified amount of foreign currency on a specified future date at an agreed rate. Currency swaps generally involve the exchange of interest payment obligations denominated in different currencies; the exchange of principal can be notional or actual. A currency option gives the buyer, on payment of a premium, the right, but not the obligation, to sell specified amounts of currency at agreed rates of exchange on or before a specified future date.
- Credit derivatives, principally credit default swaps, are used by the Group as part of its trading activity and to manage its own exposure to credit risk. A credit default swap is a swap in which one counterparty receives a premium at pre-set intervals in consideration for guaranteeing to make a specific payment should a negative credit event take place.
- Equity derivatives are also used by the Group as part of its equity-based retail product activity to eliminate the Group's exposure to fluctuations in various international stock exchange indices. Index-linked equity options are purchased which give the Group the right, but not the obligation, to buy or sell a specified amount of equities, or basket of equities, in the form of published indices on or before a specified future date.

14 Derivative financial instruments (continued)

Details of the Group's hedging instruments are set out below:

The Group – At 31 December 2020	**Maturity** Up to 1 month £m	1-3 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	Total £m
Fair value hedges						
Interest rate						
Interest rate swap						
Notional	–	27	1,560	1,868	780	4,235
Average fixed interest rate	–	5.06%	4.56%	4.56%	5.58%	
Cash flow hedges						
Interest rate						
Interest rate swap						
Notional	49	637	1,084	4,918	3,305	9,993
Average fixed interest rate	4.07%	2.19%	0.82%	1.67%	3.65%	

The Group – At 31 December 2019	Maturity Up to 1 month £m	1-3 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	Total £m
Fair value hedges						
Interest rate						
Interest rate swap						
Notional	–	1,118	88	3,205	1,640	6,051
Average fixed interest rate	–	3.87%	3.58%	4.65%	5.73%	
Cash flow hedges						
Interest rate						
Interest rate swap						
Notional	138	–	2,143	4,748	6,198	13,227
Average fixed interest rate	4.80%	–	2.04%	1.57%	2.91%	

The carrying amounts of the Group's hedging instruments are as follows:

The Group – At 31 December 2020	**Contract/notional amount £m**	**Carrying amount of the hedging instrument** Assets £m	Liabilities £m	**Changes in fair value used for calculating hedge ineffectiveness (YTD) £m**
Fair value hedges				
Interest rate				
Interest rate swaps	4,235	533	106	(23)
Cash flow hedges				
Interest rate				
Interest rate swaps	9,993	752	892	(2)

The Group – At 31 December 2019	Contract/notional amount £m	Carrying amount of the hedging instrument Assets £m	Liabilities £m	Changes in fair value used for calculating hedge ineffectiveness (YTD) £m
Fair value hedges				
Interest rate				
Interest rate swaps	6,051	880	170	(94)
Cash flow hedges				
Interest rate				
Interest rate swaps	13,227	643	826	137

All amounts are held within derivative financial instruments.

14 Derivative financial instruments (continued)

The Group's hedged items are as follows:

The Group – At 31 December 2020	Carrying amount of the hedged item: Assets £m	Carrying amount of the hedged item: Liabilities £m	Accumulated amount of fair value adjustment on the hedged item: Assets £m	Accumulated amount of fair value adjustment on the hedged item: Liabilities £m	Change in fair value of hedged item for ineffectiveness assessment (YTD) £m	Cash flow hedge reserve: Continuing hedges £m	Cash flow hedge reserve: Discontinued hedges £m
Fair value hedges							
Interest rate							
Fixed rate issuance[1]	**–**	**5,143**	**–**	**711**	**8**		
Fixed rate bonds[2]	**872**	**–**	**20**	**–**	**15**		
Cash flow hedges							
Interest rate							
Customer loans[3]					**2**	**48**	**(117)**
Customer deposits[4]					**–**	**(5)**	**13**

The Group – At 31 December 2019	Carrying amount of the hedged item: Assets £m	Carrying amount of the hedged item: Liabilities £m	Accumulated amount of fair value adjustment on the hedged item: Assets £m	Accumulated amount of fair value adjustment on the hedged item: Liabilities £m	Change in fair value of hedged item for ineffectiveness assessment (YTD) £m	Cash flow hedge reserve: Continuing hedges £m	Cash flow hedge reserve: Discontinued hedges £m
Fair value hedges							
Interest rate							
Fixed rate issuance[1]	–	6,487	–	749	93		
Fixed rate bonds[2]	722	–	5	–	4		
Cash flow hedges							
Interest rate							
Customer loans[3]					(264)	(37)	(70)
Customer deposits[4]					128	18	34

1 Included within debt securities in issue.

2 Included within financial assets at fair value through other comprehensive income.

3 Included within loans and advances to customers.

4 Included within customer deposits.

The accumulated amount of fair value hedge adjustments remaining in the balance sheet for hedged items that have ceased to be adjusted for hedging gains and losses is a liability of £391 million (2019: liability of £415 million).

Gains and losses arising from hedge accounting are summarised as follows:

The Group – At 31 December 2020	Gain (loss) recognised in other comprehensive income £m	Hedge ineffectiveness recognised in the income statement[1] £m	Amounts reclassified from reserves to income statement as: Hedged item affected income statement £m	Amounts reclassified from reserves to income statement as: Income statement line item that includes reclassified amount
Fair value hedges				
Interest rate				
Fixed rate issuance		**–**		
Cash flow hedges				
Interest rate				
Customer loans	**(8)**	**–**	**(5)**	Interest income
Customer deposits	**1**	**–**	**1**	Interest expense

14 Derivative financial instruments (continued)

The Group – At 31 December 2019	Gain (loss) recognised in other comprehensive income £m	Hedge ineffectiveness recognised in the income statement[1] £m	Amounts reclassified from reserves to income statement as: Hedged item affected income statement £m	Income statement line item that includes reclassified amount
Fair value hedges				
Interest rate				
Fixed rate issuance		4		
Cash flow hedges				
Interest rate				
Customer loans	75	–	72	Interest income
Customer deposits	(36)	–	(35)	Interest expense

1 Hedge ineffectiveness is included in the income statement within net trading income.

There were no amounts reclassified from the cash flow hedging reserve in 2019 or 2020 for which hedge accounting had previously been used but for which the hedged future cash flows are no longer expected to occur.

At 31 December 2020 £7,139 million of total recognised derivative assets of the Group and £8,337 million of total recognised derivative liabilities of the Group (2019: £10,084 million of assets and £11,184 million of liabilities) had a contractual residual maturity of greater than one year.

	2020			2019		
The Bank	**Contract/ notional amount £m**	**Fair value assets £m**	**Fair value liabilities £m**	Contract/ notional amount £m	Fair value assets £m	Fair value liabilities £m
Trading and other						
Exchange rate contracts:						
Spot, forwards and futures	**591**	**14**	**28**	1,360	23	15
Currency swaps	**32,714**	**630**	**678**	38,086	927	857
Options purchased	**2**	**–**	**–**	24	1	–
Options written	**2**	**–**	**–**	24	–	1
	33,309	**644**	**706**	39,494	951	873
Interest rate contracts:						
Interest rate swaps	**93,553**	**5,504**	**6,655**	170,525	7,800	9,157
Forward rate agreements	**2,940**	**–**	**–**	–	–	–
Options purchased	**135**	**12**	**–**	323	12	–
Options written	**250**	**–**	**1**	359	–	1
	96,878	**5,516**	**6,656**	171,207	7,812	9,158
Credit derivatives	**2,132**	**15**	**21**	1,588	6	17
Equity and other contracts	**–**	**–**	**–**	51	4	4
Total trading and other derivative assets/ liabilities	**132,319**	**6,175**	**7,383**	212,340	8,773	10,052
Hedging						
Derivatives designated as fair value hedges:						
Interest rate swaps	**4,108**	**496**	**85**	6,051	880	170
Derivatives designated as cash flow hedges:						
Interest rate swaps	**9,993**	**752**	**892**	13,227	643	826
Total hedging derivative assets/liabilities	**14,101**	**1,248**	**977**	19,278	1,523	996
Total recognised derivative assets/liabilities	**146,420**	**7,423**	**8,360**	231,618	10,296	11,048

14 Derivative financial instruments (continued)

Details of the Bank's hedging instruments are set out below:

	Maturity					
The Bank – At 31 December 2020	**Up to 1 month £m**	**1-3 months £m**	**3 - 12 months £m**	**1-5 years £m**	**Over 5 years £m**	**Total £m**
Fair value hedges						
Interest rate						
Interest rate swap						
Notional	–	**27**	**1,560**	**1,868**	**653**	**4,108**
Average fixed interest rate	–	**5.06%**	**4.56%**	**4.56%**	**5.67%**	
Cash flow hedges						
Interest rate						
Interest rate swap						
Notional	**49**	**637**	**1,084**	**4,918**	**3,305**	**9,993**
Average fixed interest rate	**4.07%**	**2.19%**	**0.82%**	**1.67%**	**3.65%**	

	Maturity					
The Bank – At 31 December 2019	Up to 1 month £m	1-3 months £m	3 - 12 months £m	1-5 years £m	Over 5 years £m	Total £m
Fair value hedges						
Interest rate						
Interest rate swap						
Notional	–	1,118	88	3,205	1,640	6,051
Average fixed interest rate	–	3.87%	3.58%	4.65%	5.73%	
Cash flow hedges						
Interest rate						
Interest rate swap						
Notional	138	–	2,143	4,748	6,198	13,227
Average fixed interest rate	4.80%	–	2.04%	1.57%	2.91%	

The carrying amounts of the Bank's hedging instruments are as follows:

		Carrying amount of the hedging instrument		
The Bank – At 31 December 2020	**Contract/notional amount £m**	**Assets £m**	**Liabilities £m**	**Changes in fair value used for calculating hedge ineffectiveness (YTD) £m**
Fair value hedges				
Interest rate				
Interest rate swaps	**4,108**	**496**	**85**	**(23)**
Cash flow hedges				
Interest rate	**9,993**	**752**	**892**	**(2)**
Interest rate swaps				

		Carrying amount of the hedging instrument		
The Bank – 31 December 2019	Contract/notional amount £m	Assets £m	Liabilities £m	Changes in fair value used for calculating hedge ineffectiveness (YTD) £m
Fair value hedges				
Interest rate				
Interest rate swaps	6,051	880	170	(94)
Cash flow hedges				
Interest rate				
Interest rate swaps	13,227	643	826	137

14 Derivative financial instruments (continued)

All amounts are held within derivative financial instruments.

The Bank's hedged items are as follows:

The Bank – At 31 December 2020	Carrying amount of the hedged item Assets £m	Carrying amount of the hedged item Liabilities £m	Accumulated amount of fair value adjustment on the hedged item Assets £m	Accumulated amount of fair value adjustment on the hedged item Liabilities £m	Change in fair value of hedged item for ineffectiveness assessment (YTD) £m	Cash flow hedge reserve Continuing hedges £m	Cash flow hedge reserve Discontinued hedges £m
Fair value hedges							
Interest rate							
Fixed rate issuance[1]	–	5,185	–	723	8		
Fixed rate bonds[2]	872	–	20	–	15		
Cash flow hedges							
Interest rate							
Customer loans[3]					2	48	(117)
Customer deposits[4]					–	(5)	13

The Bank – At 31 December 2019	Carrying amount of the hedged item Assets £m	Carrying amount of the hedged item Liabilities £m	Accumulated amount of fair value adjustment on the hedged item Assets £m	Accumulated amount of fair value adjustment on the hedged item Liabilities £m	Change in fair value of hedged item for ineffectiveness assessment (YTD) £m	Cash flow hedge reserve Continuing hedges £m	Cash flow hedge reserve Discontinued hedges £m
Fair value hedges							
Interest rate							
Fixed rate issuance[1]	–	6,487	–	749	93		
Fixed rate bonds[2]	722	–	5	–	4		
Cash flow hedges							
Interest rate							
Customer loans[3]					(264)	(37)	(70)
Customer deposits[4]					128	18	34

1 Included within debt securities in issue.
2 Included within financial assets at fair value through other comprehensive income.
3 Included within loans and advances to customers.
4 Included within customer deposits.

The accumulated amount of fair value hedge adjustments remaining in the balance sheet for hedged items that have ceased to be adjusted for hedging gains and losses is a liability £391 million (2019: liability of £415 million).
Gains and losses arising from hedge accounting are summarised as follows:

The Bank – At 31 December 2020	Gain (loss) recognised in other comprehensive income £m	Hedge ineffectiveness recognised in the income statement[1] £m	Amounts reclassified from reserves to income statement as: Hedged item affected income statement £m	Amounts reclassified from reserves to income statement as: Income statement line item that includes reclassified amount
Fair value hedges				
Interest rate				
Fixed rate issuance		(1)		
Fixed rate bonds		1		
Cash flow hedges				
Interest rate				
Customer loans	(8)	–	(5)	Interest income
Customer deposits	1	–	1	Interest expense

14 Derivative financial instruments (continued)

The Bank – At 31 December 2019	(Loss) gain recognised in other comprehensive income £m	Hedge ineffectiveness recognised in the income statement[1] £m	Amounts reclassified from reserves to income statement as: Hedged item affected income statement £m	Income statement line item that includes reclassified amount
Fair value hedges				
Interest rate				
Fixed rate issuance		4		
Cash flow hedges				
Interest rate				
Customer loans	75	–	72	Interest income
Customer deposits	(36)	–	(35)	Interest expense

1 Hedge ineffectiveness is included in the income statement within net interest income.

There were no amounts reclassified from the cash flow hedging reserve in 2019 or 2020 for which hedge accounting had previously been used but for which the hedged future cash flows are no longer expected to occur.

At 31 December 2020 £7,139 million of total recognised derivative assets of the Bank and £8,046 million of total recognised derivative liabilities of the Bank (2019: £10,099 million of assets and £10,875 million of liabilities) had a contractual residual maturity of greater than one year.

15 Financial assets at amortised cost

The Group
Loans and advances to banks

	Gross carrying amount				Allowance for expected credit losses			
	Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m	Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m
Loans and advances to banks								
At 1 January 2020	311	–	–	311	–	–	–	–
Exchange and other adjustments	17	–	–	17	–	–	–	–
Repayments	(121)	–	–	(121)	–	–	–	–
At 31 December 2020	207	–	–	207	–	–	–	–
Allowance for impairment losses	–	–	–	–				
Net carrying amount	207	–	–	207				
Loans and advances to customers								
At 1 January 2020	229,741	24,996	5,663	260,400	149	749	1,187	2,085
Exchange and other adjustments	94	1	(2)	93	(2)	1	24	23
Transfers to Stage 1	3,011	(3,004)	(7)	–	52	(51)	(1)	–
Transfers to Stage 2	(15,009)	15,731	(722)	–	(63)	120	(57)	–
Transfers to Stage 3	(401)	(1,598)	1,999	–	(6)	(108)	114	–
Impact of transfers between stages	(12,399)	11,129	1,270	–	(33)	372	197	536
					(50)	333	253	536
Other changes in credit quality					367	88	587	1,042
Additions (repayments)	10,106	(1,665)	(702)	7,739	22	(25)	(28)	(31)
Charge to the income statement					339	396	812	1,547
Disposal of business	(796)	(24)	–	(820)	–	–	–	–
Advances written off			(552)	(552)			(552)	(552)
Recoveries of advances written off in previous years			98	98			98	98
Discount unwind							(9)	(9)
At 31 December 2020	226,746	34,437	5,775	266,958	486	1,146	1,560	3,192
Allowance for impairment losses	(486)	(1,146)	(1,560)	(3,192)				
Net carrying amount	226,260	33,291	4,215	263,766				
Debt securities								
At 1 January and 31 December 2020	–	–	1	1	–	–	1	1
Allowance for impairment losses	–	–	(1)	(1)				
Net carrying amount	–	–	–	–				
Due from fellow Lloyds Banking Group undertakings	28,997	–	–	28,997				
Allowance for impairment losses	(9)	–	–	(9)				
Net carrying amount	28,988	–	–	28,988				
Total financial assets at amortised cost	255,455	33,291	4,215	292,961				

During the year, the economic outlook deteriorated materially as a consequence of the COVID-19 pandemic. The Group's economic assumptions are outlined in note 3 and these have resulted in a significant increase in the expected credit loss (ECL) allowance.

15 Financial assets at amortised cost (continued)

Movements in allowance for expected credit losses in respect of undrawn balances were as follows:

The Group
Undrawn balances

	Allowance for expected credit losses			
	Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m
At 1 January 2020	26	28	1	55
Exchange and other adjustments	(1)	—	1	—
Transfers to Stage 1	8	(8)	—	—
Transfers to Stage 2	(3)	3	—	—
Transfers to Stage 3	—	(3)	3	—
Impact of transfer between stages	(4)	23	11	30
	1	15	14	30
Other items charged to the income statement	28	26	(10)	44
Charge to the income statement	29	41	4	74
At 31 December 2020	54	69	6	129

The Group's total impairment allowances were as follows:

The Group

	Allowance for expected credit losses			
	Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m
In respect of:				
Loans and advances to customers	486	1,146	1,560	3,192
Debt securities	—	—	1	1
Due from fellow Lloyds Banking Group undertakings	9	—	—	9
Financial assets at amortised cost	495	1,146	1,561	3,202
Provisions in relation to loan commitments and financial guarantees	54	69	6	129
Total	549	1,215	1,567	3,331

15 Financial assets at amortised cost (continued)

The Group
Loans and advances to banks

	Gross carrying amount				Allowance for expected credit losses			
	Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m	Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m
Loans and advances to banks								
At 1 January 2019	471	–	–	471	–	–	–	–
Exchange and other adjustments	(20)	–	–	(20)	–	–	–	–
Repayments	(140)	–	–	(140)	–	–	–	–
At 31 December 2019	311	–	–	311	–	–	–	–
Allowance for impairment losses	—	–	–	—				
Net carrying amount	311	–	–	311				

Loans and advances to customers

	Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m	Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m
At 1 January 2019	232,951	25,345	6,143	264,439	149	858	1,108	2,115
Exchange and other adjustments	(265)	(15)	25	(255)	1	(7)	64	58
Transfers to Stage 1	4,524	(4,515)	(9)	–	80	(76)	(4)	–
Transfers to Stage 2	(7,591)	8,502	(911)	–	(22)	115	(93)	–
Transfers to Stage 3	(677)	(1,378)	2,055	–	(10)	(118)	128	–
Impact of transfers between stages	(3,744)	2,609	1,135	–	(65)	129	130	194
					(17)	50	161	194
Other changes in credit quality					8	(91)	456	373
Additions (repayments)	7,162	(2,583)	(1,102)	3,477	14	(52)	(81)	(119)
Charge to the income statement					5	(93)	536	448
Disposal of business	(6,363)	(360)	(42)	(6,765)	(6)	(9)	(14)	(29)
Advances written off			(665)	(665)			(665)	(665)
Recoveries of advances written off in previous years			169	169			169	169
Discount unwind							(11)	(11)
At 31 December 2019	229,741	24,996	5,663	260,400	149	749	1,187	2,085
Allowance for impairment losses	(149)	(749)	(1,187)	(2,085)				
Net carrying amount	229,592	24,247	4,476	258,315				

Debt securities

	Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m	Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m
At 1 January 2019	–	–	13	13	–	–	13	13
Financial assets that have been written off during the year			(12)	(12)			(12)	(12)
At 31 December 2019	–	–	1	1	–	–	1	1
Allowance for impairment losses	–	–	(1)	(1)				
Net carrying amount	–	–	–	–				
Due from fellow Lloyds Banking Group undertakings	97,541	–	–	97,541				
Allowance for impairment losses	(7)	–	–	(7)				
Net carrying amount	97,534	–	–	97,534				
Total financial assets at amortised cost	327,437	24,247	4,476	356,160				

15 Financial assets at amortised cost (continued)

The Group
Undrawn balances

	Allowance for expected credit losses			
	Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m
At 1 January 2019	24	23	3	50
Transfers to Stage 1	5	(5)	—	—
Transfers to Stage 2	(1)	1	—	—
Transfers to Stage 3	—	(1)	1	—
Impact of transfer between stages	(4)	6	(1)	1
	—	1	—	1
Other items charged to the income statement	2	4	(2)	4
Charge to the income statement	2	5	(2)	5
At 31 December 2019	26	28	1	55

The Group's total impairment allowances were as follows:

The Group

	Allowance for expected credit losses			
	Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m
In respect of:				
Loans and advances to customers	149	749	1,187	2,085
Debt securities	—	—	1	1
Due from fellow Lloyds Banking Group undertakings	7	—	—	7
Financial assets at amortised cost	156	749	1,188	2,093
Provisions in relation to loan commitments and financial guarantees	26	28	1	55
Total	182	777	1,189	2,148

15 Financial assets at amortised cost (continued)

The Bank
Loans and advances to banks

	Gross carrying amount				Allowance for expected credit losses			
	Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m	Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m
Loans and advances to banks								
At 1 January 2020	307	–	–	307	–	–	–	–
Exchange and other adjustments	18	–	–	18	–	–	–	–
Repayments	(120)	–	–	(120)	–	–	–	–
At 31 December 2020	205	–	–	205	–	–	–	–
Allowance for impairment losses	–	–	–	–				
Net carrying amount	205	–	–	205				
Loans and advances to customers								
At 1 January 2020	225,703	23,857	5,307	254,867	147	682	1,107	1,936
Exchange and other adjustments	58	–	(2)	56	1	2	23	26
Transfers to Stage 1	2,930	(2,923)	(7)	–	50	(49)	(1)	–
Transfers to Stage 2	(14,422)	15,081	(659)	–	(62)	113	(51)	–
Transfers to Stage 3	(389)	(1,478)	1,867	–	(6)	(99)	105	–
Impact of transfers between stages	(11,881)	10,680	1,201	–	(31)	357	184	510
					(49)	322	237	510
Other changes in credit quality					360	81	602	1,043
Additions (repayments)	10,457	(1,563)	(640)	8,254	23	(21)	(25)	(23)
Charge to the income statement					334	382	814	1,530
Advances written off			(536)	(536)			(536)	(536)
Recoveries of advances written off in previous years			91	91			91	91
Discount unwind							(12)	(12)
At 31 December 2020	224,337	32,974	5,421	262,732	482	1,066	1,487	3,035
Allowance for impairment losses	(482)	(1,066)	(1,487)	(3,035)				
Net carrying amount	223,855	31,908	3,934	259,697				
Debt securities								
At 1 January and 31 December 2020	–	–	1	1	–	–	1	1
Allowance for impairment losses	–	–	(1)	(1)				
Net carrying amount	–	–	–	–				
Due from fellow Lloyds Banking Group undertakings	38,735	–	88	38,823				
Allowance for impairment losses	(9)	–	(88)	(97)				
Net carrying amount	38,726	–	–	38,726				
Total financial assets at amortised cost	262,786	31,908	3,934	298,628				

15 Financial assets at amortised cost (continued)

The Bank
Undrawn balances

	Allowance for expected credit losses			
	Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m
At 1 January 2020	26	28	1	55
Exchange and other adjustments	(1)	—	1	—
Transfers to Stage 1	8	(8)	—	—
Transfers to Stage 2	(3)	3	—	—
Transfers to Stage 3	—	(3)	3	—
Impact of transfer between stages	(4)	22	11	29
	1	14	14	29
Other items charged to the income statement	28	27	(10)	45
Charge to the income statement	29	41	4	74
At 31 December 2020	54	69	6	129

The Bank's total impairment allowances were as follows:

The Bank

	Allowance for expected credit losses			
	Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m
In respect of:				
Loans and advances to customers	482	1,066	1,487	3,035
Debt securities	—	—	1	1
Due from fellow Lloyds Banking Group undertakings	9	—	88	97
Financial assets at amortised cost	491	1,066	1,576	3,133
Provisions in relation to loan commitments and financial guarantees	54	69	6	129
Total	545	1,135	1,582	3,262

15 Financial assets at amortised cost (continued)

The Bank
Loans and advances to banks

	Gross carrying amount				Allowance for expected credit losses			
	Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m	Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m
Loans and advances to banks								
At 1 January 2019	471	–	–	471	–	–	–	–
Exchange and other adjustments	(20)	–	–	(20)	–	–	–	–
Repayments	(144)	–	–	(144)	–	–	–	–
At 31 December 2019	307	–	–	307	–	–	–	–
Allowance for impairment losses	—	–	–	—				
Net carrying amount	307	–	–	307				
Loans and advances to customers								
At 1 January 2019	229,138	24,086	5,676	258,900	147	773	990	1,910
Exchange and other adjustments	(233)	(15)	27	(221)	(1)	(7)	67	59
Transfers to Stage 1	4,315	(4,306)	(9)	–	75	(71)	(4)	–
Transfers to Stage 2	(7,371)	8,198	(827)	–	(21)	99	(78)	–
Transfers to Stage 3	(682)	(1,282)	1,964	–	(9)	(105)	114	–
Impact of transfers between stages	(3,738)	2,610	1,128	–	(60)	125	124	189
					(15)	48	156	189
Other changes in credit quality					7	(80)	476	403
Additions (repayments)	6,899	(2,464)	(998)	3,437	15	(43)	(69)	(97)
Charge to the income statement					7	(75)	563	495
Disposal of business	(6,363)	(360)	(42)	(6,765)	(6)	(9)	(14)	(29)
Advances written off			(648)	(648)			(648)	(648)
Recoveries of advances written off in previous years			164	164			164	164
Discount unwind							(15)	(15)
At 31 December 2019	225,703	23,857	5,307	254,867	147	682	1,107	1,936
Allowance for impairment losses	(147)	(682)	(1,107)	(1,936)				
Net carrying amount	225,556	23,175	4,200	252,931				
Debt securities								
At 1 January 2019	–	–	13	13	–	–	13	13
Financial assets that have been written off during the year			(12)	(12)			(12)	(12)
At 31 December 2019	–	–	1	1	–	–	1	1
Allowance for impairment losses	–	–	(1)	(1)				
Net carrying amount	–	–	–	–				
Due from fellow Lloyds Banking Group undertakings	108,945	–	106	109,051				
Allowance for impairment losses	(10)	–	(106)	(116)				
Net carrying amount	108,935	–	–	108,935				
Total financial assets at amortised cost	334,798	23,175	4,200	362,173				

15 Financial assets at amortised cost (continued)

The Bank
Undrawn balances

	Allowance for expected credit losses			
	Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m
At 1 January 2019	24	23	3	50
Transfers to Stage 1	5	(5)	—	—
Transfers to Stage 2	(1)	1	—	—
Transfers to Stage 3	—	(1)	1	—
Impact of transfer between stages	(4)	6	(1)	1
	—	1	—	1
Other items charged to the income statement	2	4	(2)	4
Charge to the income statement	2	5	(2)	5
At 31 December 2019	26	28	1	55

The Bank's total impairment allowances were as follows:

The Bank

	Allowance for expected credit losses			
	Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m
In respect of:				
Loans and advances to customers	147	682	1,107	1,936
Debt securities	—	—	1	1
Due from fellow Lloyds Banking Group undertakings	10	—	106	116
Financial assets at amortised cost	157	682	1,214	2,053
Provisions in relation to loan commitments and financial guarantees	26	28	1	55
Total	183	710	1,215	2,108

The movement tables are compiled by comparing the position at 31 December to that at the beginning of the year. Transfers between stages are deemed to have taken place at the start of the reporting period, with all other movements shown in the stage in which the asset is held at 31 December.

Additions (repayments) comprise new loans originated and repayments of outstanding balances throughout the reporting period. Loans which are written off in the period are first transferred to Stage 3 before acquiring a full allowance and subsequent write-off.

At 31 December 2020 £248,314 million (2019: £245,357 million) of loans and advances to customers of the Group and £244,626 million (2019: £240,181 million) of the Bank had a contractual residual maturity of greater than one year.

At 31 December 2020 £56 million (2019: £265 million) of loans and advances to banks of the Group and the Bank had a contractual residual maturity of greater than one year.

16 Finance lease receivables

The Group's finance lease receivables are classified as loans and advances to customers and accounted for at amortised cost. The balance is analysed as follows:

The Group	2020 £m	2019 £m
Gross investment in finance leases, receivable:		
Not later than 1 year	31	29
Later than 1 year and not later than 2 years	32	32
Later than 2 years and not later than 3 years	50	32
Later than 3 years and not later than 4 years	26	50
Later than 4 years and not later than 5 years	30	29
Later than 5 years	172	200
	341	372
Unearned future finance income on finance leases	(105)	(120)
Rentals received in advance	(1)	(1)
Net investment in finance leases	235	251

The net investment in finance leases represents amounts recoverable as follows:

The Group	2020 £m	2019 £m
Not later than 1 year	10	10
Later than 1 year and not later than 2 years	17	16
Later than 2 years and not later than 3 years	37	17
Later than 3 years and not later than 4 years	14	37
Later than 4 years and not later than 5 years	19	17
Later than 5 years	138	154
Net investment in finance leases	235	251

Equipment leased to customers under finance leases primarily relates to structured financing transactions to fund the purchase of aircraft, ships and other large individual value items. There was an allowance for uncollectable finance lease receivables included in the allowance for impairment losses for the Group of £nil (2019: £nil).

17 Financial assets at fair value through other comprehensive income

31 December 2020	**The Group and the Bank £m**
Corporate and other debt securities	**2,395**

31 December 2019	The Group and the Bank £m
Corporate and other debt securities	2,253

At 31 December 2020 £2,114 million (2019: £2,126 million) of financial assets at fair value through other comprehensive income of the Group and the Bank had a contractual residual maturity of greater than one year.

All assets have been assessed as Stage 1 at 1 January and 31 December 2020.

18 Goodwill

	The Group and the Bank	
	2020 £m	2019 £m
At 1 January and 31 December	**325**	325

The goodwill held in the Group's balance sheet is tested at least annually for impairment. This compares the estimated recoverable amount, being the higher of a cash-generating unit's fair value less costs to sell and its value in use, with the carrying value. When this indicates that the carrying value is not recoverable it is written down through the income statement as goodwill impairment. For the purposes of impairment testing the goodwill is allocated to the appropriate cash generating unit; the entire balance of £325 million has been allocated to retail banking activities.

The recoverable amount of goodwill carried at 31 December 2020 has been based upon value in use. This calculation uses cash flow projections based upon the Group's business plan where the main assumptions used for planning purposes relate to the current economic outlook and opinions in respect of economic growth, unemployment, property markets, interest rates and credit quality. Cash flows for the period subsequent to the term of the business plan are not considered for the purposes of impairment testing. The discount rate used in discounting the projected cash flows is 10 per cent (pre-tax) reflecting, inter alia, the perceived risks within those businesses. Management believes that any reasonably possible change in the key assumptions would not cause the recoverable amount to fall below the balance sheet carrying value.

19 Other intangible assets

	The Group			**The Bank**
	Brands £m	**Capitalised software enhancements £m**	**Total £m**	**Capitalised software enhancements £m**
Cost:				
At 1 January 2019	10	295	305	295
Additions	–	51	51	51
Disposals and write-offs	(10)	(2)	(12)	(2)
At 31 December 2019	–	344	344	344
Additions	**–**	**119**	**119**	**119**
At 31 December 2020	**–**	**463**	**463**	**463**
Accumulated amortisation:				
At 1 January 2019	10	175	185	175
Charge for the year (note 9)	–	31	31	31
Disposals and write-offs	(10)	–	(10)	–
At 31 December 2019	–	206	206	206
Charge for the year (note 9)	**–**	**33**	**33**	**33**
At 31 December 2020	**–**	**239**	**239**	**239**
Balance sheet amount at 31 December 2020	**–**	**224**	**224**	**224**
Balance sheet amount at 31 December 2019	–	138	138	138

Capitalised software enhancements principally comprise identifiable and directly associated internal staff and other costs.

20 Property, plant and equipment

	The Group						The Bank			
	Investment properties £m	Premises £m	Equipment £m	Operating lease assets £m	Right-of-use asset[1] £m	Total £m	Premises £m	Equipment £m	Right-of-use asset[1] £m	Total £m
Cost or valuation:										
At 1 January 2019	35	750	541	46	748	2,120	715	529	748	1,992
Additions	–	56	32	–	81	169	56	32	81	169
Expenditure on investment properties	13	–	–	–	–	13	–	–	–	–
Change in fair value of investment properties	(8)	–	–	–	–	(8)	–	–	–	–
Disposals and write-offs	(25)	(51)	(12)	(46)	(10)	(144)	(34)	–	(10)	(44)
At 31 December 2019	15	755	561	–	819	2,150	737	561	819	2,117
Additions	**–**	**29**	**22**	**–**	**18**	**69**	**29**	**22**	**18**	**69**
Expenditure on investment properties	**9**	**–**	**–**	**–**	**–**	**9**	**–**	**–**	**–**	**–**
Change in fair value of investment properties	**(20)**	**–**	**–**	**–**	**–**	**(20)**	**–**	**–**	**–**	**–**
Disposals and write-offs	**–**	**(72)**	**(29)**	**–**	**(20)**	**(121)**	**(54)**	**(29)**	**(20)**	**(103)**
At 31 December 2020	**4**	**712**	**554**	**–**	**817**	**2,087**	**712**	**554**	**817**	**2,083**
Accumulated depreciation and impairment:										
At 1 January 2019	–	374	210	11	–	595	358	209	–	567
Depreciation charge for the year (note 9)	–	54	59	–	91	204	54	59	91	204
Disposals and write-offs	–	(39)	(4)	(11)	(2)	(56)	(23)	(3)	(2)	(28)
At 31 December 2019	–	389	265	–	89	743	389	265	89	743
Depreciation charge for the year (note 9)	**–**	**54**	**53**	**–**	**92**	**199**	**54**	**53**	**92**	**199**
Disposals and write-offs	**–**	**(48)**	**(25)**	**–**	**(12)**	**(85)**	**(48)**	**(25)**	**(12)**	**(85)**
At 31 December 2020	**–**	**395**	**293**	**–**	**169**	**857**	**395**	**293**	**169**	**857**
Balance sheet amount at 31 December 2020	**4**	**317**	**261**	**–**	**648**	**1,230**	**317**	**261**	**648**	**1,226**
Balance sheet amount at 31 December 2019	15	366	296	–	730	1,407	348	296	730	1,374

1 Primarily premises

The table above analyses movements in investment properties, all of which are categorised as level 3. See note 39 for details of levels in the fair value hierarchy.

21 Investment in subsidiary undertakings

The Bank	2020 £m	2019 £m
At 1 January	**74**	83
Impairment	**–**	(9)
At 31 December	**74**	74

Details of the subsidiaries and related undertakings are given on pages 122 to 123 and are incorporated by reference.

Certain subsidiary companies currently have insufficient distributable reserves to make dividend payments, however, there were no further significant restrictions on any of the Bank's subsidiaries in paying dividends or repaying loans and advances. All regulated subsidiaries are required to maintain capital at levels agreed with the regulators; this may impact those subsidiaries' ability to make distributions.

22 Other assets

	The Group		The Bank	
	2020 £m	2019 £m	**2020 £m**	2019 £m
Settlement balances	**92**	41	**86**	41
Investments in joint ventures and associates	**1**	1	**1**	1
Other assets and prepayments	**171**	314	**159**	319
Total other assets	**264**	356	**246**	361

23 Financial liabilities at fair value through profit or loss

	The Group	
	2020 £m	2019 £m
Debt securities in issue	**45**	47

At 31 December 2020 £45 million (2019: £47 million) of financial liabilities at fair value through profit or loss of the Group had a contractual residual maturity of greater than one year.

24 Debt securities in issue

	The Group		The Bank	
	2020 £m	2019 £m	**2020 £m**	2019 £m
Medium-term notes issued	**2,065**	1,106	**2,065**	1,106
Covered bonds (note 25)	**3,243**	4,529	**3,243**	4,529
Securitisation notes (note 25)	**2,989**	5,569	**–**	–
	8,297	11,204	**5,308**	5,635
Other amounts due to fellow Group undertakings	**–**	–	**1,704**	4,065
Total debt securities in issue	**8,297**	11,204	**7,012**	9,700

At 31 December 2020 £5,898 million (2019: £8,090 million) of debt securities in issue of the Group and £3,543 million (2019: £4,376 million) of the Bank had a contractual residual maturity of greater than one year.

25 Securitisations and covered bonds

Securitisation programmes

The Group's balance sheet includes loans securitised under the Group's securitisation programmes, the majority of which have been sold by Group companies to bankruptcy-remote structured entities. As the structured entities are funded by the issue of debt on terms whereby the majority of the risks and rewards of the portfolio are retained by the Group company, the structured entities are consolidated fully and all of these loans are retained on the Group's balance sheet, with the related notes in issue included within debt securities in issue.

Covered bond programmes

Certain loans and advances to customers have been assigned to bankruptcy remote limited liability partnerships to provide security for issues of covered bonds by the Group. The Group retains all of the risks and rewards associated with these loans and the partnerships are consolidated fully with the loans retained on the Group's balance sheet and the related covered bonds in issue included within debt securities in issue.

The Group's principal securitisation and covered bond programmes, together with the balances of the advances subject to these arrangements and the carrying value of the notes in issue at 31 December, are listed below. The notes in issue are reported in notes 23 and 24.

	2020		2019	
The Group	**Loans and advances securitised £m**	**Notes in issue £m**	Loans and advances securitised £m	Notes in issue £m
Securitisation programmes				
UK residential mortgages	**23,504**	**21,119**	25,302	22,947
Credit card receivables	**3,226**	**4,340**	4,581	5,767
Commercial loans	**774**	**774**	534	534
	27,504	**26,233**	30,417	29,248
Less held by the Group		**(23,199)**		(23,632)
Total securitisation programmes (notes 23 and 24)[1]		**3,034**		5,616
Covered bond programmes				
Residential mortgage-backed	**3,076**	**2,743**	5,206	4,029
Social housing loan-backed	**980**	**600**	1,552	600
	4,056	**3,343**	6,758	4,629
Less held by the Group		**(100)**		(100)
Total covered bond programmes (note 24)		**3,243**		4,529
Total securitisation and covered bond programmes		**6,277**		10,145

1 Includes £45 million (2019: £47 million) of securitisation notes accounted for at fair value through profit or loss.

Cash deposits of £1,485 million (2019: £2,000 million) which support the debt securities issued by the structured entities, the term advances related to covered bonds and other legal obligations are held by the Group. Additionally, the Group has certain contractual arrangements to provide liquidity facilities to some of these structured entities. At 31 December 2020 these obligations had not been triggered; the maximum exposure under these facilities was £4 million (2019: £12 million).

The Group has a number of covered bond programmes, for which limited liability partnerships have been established to ringfence asset pools and guarantee the covered bonds issued by the Group. At the reporting date the Group had over-collateralised these programmes as set out in the table above to meet the terms of the programmes, to secure the rating of the covered bonds and to provide operational flexibility. From time-to-time, the obligations of the Group to provide collateral may increase due to the formal requirements of the programmes. The Group may also voluntarily contribute collateral to support the ratings of the covered bonds.

The Group recognises the full liabilities associated with its securitisation and covered bond programmes within debt securities in issue, although the obligations of the Group in respect of its securitisation issuances are limited to the cash flows generated from the underlying assets. The Group could be required to provide additional support to a number of the securitisation programmes to support the credit ratings of the debt securities issued, in the form of increased cash reserves and the holding of subordinated notes. Further, certain programmes contain contractual obligations that require the Group to repurchase assets should they become credit impaired.

The Group has not provided financial or other support by voluntarily offering to repurchase assets from any of its public securitisation programmes during 2020 (2019: none).

26 Other liabilities

	The Group		The Bank	
	2020 £m	2019 £m	**2020 £m**	2019 £m
Settlement balances	**24**	261	**24**	261
Lease liabilities	**699**	770	**699**	770
Other creditors and accruals	**666**	800	**497**	648
Total other liabilities	**1,389**	1,831	**1,220**	1,679

The maturity of the lease liabilities was as follows:

	The Group and the Bank	
	2020 £m	2019 £m
Not later than 1 year	**102**	101
Later than 1 year and not later than 2 years	**90**	96
Later than 2 years and not later than 3 years	**77**	85
Later than 3 years and not later than 4 years	**68**	74
Later than 4 years and not later than 5 years	**60**	65
Later than 5 years	**302**	349
	699	770

27 Deferred tax

The Group's and the Bank's deferred tax assets and liabilities are as follows:

	The Group		The Bank	
	2020 £m	2019 £m	**2020 £m**	2019 £m
Statutory position				
Deferred tax assets	**1,721**	1,652	**1,718**	1,647
Deferred tax liabilities	**–**	–	**–**	–
Net deferred tax asset	**1,721**	1,652	**1,718**	1,647
Tax disclosure				
Deferred tax assets	**1,786**	1,689	**1,782**	1,684
Deferred tax liabilities	**(65)**	(37)	**(64)**	(37)
Net deferred tax asset	**1,721**	1,652	**1,718**	1,647

The statutory position reflects the deferred tax assets and liabilities as disclosed in the consolidated balance sheet and takes into account the ability of the Group and the Company to net assets and liabilities where there is a legally enforceable right of offset. The tax disclosure of deferred tax assets and liabilities ties to the amounts outlined in the tables below which splits the deferred tax assets and liabilities by type, before such netting.

As a result of legislation enacted in 2016, the UK corporation tax rate had been expected to reduce from 19 per cent to 17 per cent on 1 April 2020. The Group measures its deferred tax assets and liabilities at the value expected to be recoverable or payable in future periods, and so at 31 December 2019 substantially all of its deferred tax was measured using the 17 per cent rate. During the 2019 election campaign, however, the UK Government stated its intention to maintain the corporation tax rate at 19 per cent, and this rate was substantially enacted on 17 March 2020. The Group therefore remeasured its deferred tax assets and liabilities at 19 per cent. The deferred tax impact of this re-measurement in 2020 is a credit of £182 million in the income statement and a credit of £1 million in other comprehensive income.

On 3 March 2021, the UK Government announced its intention to increase the rate of corporation tax from 19 per cent to 25 per cent with effect from 1 April 2023. Had this change in corporation tax been enacted on 31 December 2020, the impact would have been to increase net deferred tax assets by approximately £450 million. The UK Government also announced that in 2021 it will undertake a review of the surcharge on banking companies, its intention being to ensure that the combined rate of corporation tax and banking surcharge on bank profits does not increase substantially from its current level. The results of this review are expected to be announced later in 2021.

27 Deferred tax (continued)

Movements in deferred tax liabilities and assets (before taking into consideration the offsetting of balances within the same taxing jurisdiction) can be summarised as follows:

The Group **Deferred tax assets**	Tax losses £m	Property, plant and equipment £m	Provisions £m	Share-based payments £m	Other revaluations[1] £m	Derivatives £m	Other temporary differences £m	Total £m
At 1 January 2019	1,498	167	128	5	3	24	6	1,831
(Charge) credit to the income statement	(96)	(23)	(36)	6	–	–	18	(131)
Charge to other comprehensive income	–	–	–	–	(1)	(10)	–	(11)
At 31 December 2019	1,402	144	92	11	2	14	24	1,689
Credit (charge) to the income statement	**145**	**(41)**	**(4)**	**(5)**	**(2)**	**–**	**1**	**94**
Credit to other comprehensive income	**–**	**–**	**–**	**–**	**–**	**3**	**–**	**3**
At 31 December 2020	**1,547**	**103**	**88**	**6**	**–**	**17**	**25**	**1,786**

Deferred tax liabilities	Capitalised software enhancements £m	Other revaluations[1] £m	Other temporary differences £m	Total £m
At 1 January 2019	(5)	–	(25)	(30)
Credit (charge) to the income statement	3	–	(4)	(1)
Charge to other comprehensive income	–	–	(6)	(6)
At 31 December 2019	(2)	–	(35)	(37)
Charge to the income statement	**(14)**	**(4)**	**(1)**	**(19)**
Charge to other comprehensive income	**–**	**(2)**	**(7)**	**(9)**
At 31 December 2020	**(16)**	**(6)**	**(43)**	**(65)**

The Bank **Deferred tax assets**	Tax losses £m	Property, plant and equipment £m	Provisions £m	Share-based payments £m	Other revaluations[1] £m	Derivatives £m	Other temporary differences £m	Total £m
At 1 January 2019	1,478	187	124	5	3	24	6	1,827
(Charge) credit to the income statement	(96)	(22)	(36)	6	(3)	–	18	(133)
Charge to other comprehensive income	–	–	–	–	–	(10)	–	(10)
At 31 December 2019	1,382	165	88	11	–	14	24	1,684
Credit (charge) to the income statement	**143**	**(38)**	**(3)**	**(5)**	**–**	**–**	**(2)**	**95**
Credit to other comprehensive income	**–**	**–**	**–**	**–**	**–**	**3**	**–**	**3**
At 31 December 2020	**1,525**	**127**	**85**	**6**	**–**	**17**	**22**	**1,782**

Deferred tax liabilities	Capitalised software enhancements £m	Other revaluations[1] £m	Other temporary differences £m	Total £m
At 1 January 2019	(5)	–	(22)	(27)
Credit (charge) to the income statement	3	(2)	(3)	(2)
Charge to other comprehensive income	–	–	(7)	(7)
Exchange and other adjustments	–	–	(1)	(1)
At 31 December 2019	(2)	(2)	(33)	(37)
Charge to the income statement	**(14)**	**–**	**(3)**	**(17)**
Charge to other comprehensive income	**–**	**(4)**	**(7)**	**(11)**
Exchange and other adjustments	**–**	**–**	**1**	**1**
At 31 December 2020	**(16)**	**(6)**	**(42)**	**(64)**

1 Financial assets at fair value through other comprehensive income.

Deferred tax not recognised

Deferred tax assets of approximately £11 million (2019: £24 million) for the Group and the Bank have not been recognised in respect of £59 million of UK tax losses and other temporary differences which can only be used to offset future capital gains. UK capital losses can be carried forward indefinitely.

27 Deferred tax (continued)

In addition, no deferred tax asset is recognised in respect of unrelieved foreign tax credits of £40 million (2019 £40 million) for the Group and the Bank, as there are no expected future taxable profits against which the credits can be utilised. These credits can be carried forward indefinitely.

No deferred tax has been recognised in respect of foreign trade losses where it is not more likely than not that we will be able to utilise them in future periods. Of the asset not recognised, £33 million for the Group and £nil for the Bank (2019: £35 million for the Group and £nil for the Bank) relates to losses that will expire if not used within 20 years, and £37 million for the Group and £36 million for the Bank (2019: £38 million for the Group and £37 million for the Bank) relates to losses with no expiry date.

As a result of parent company exemptions on dividends from subsidiaries and on capital gains on disposal there are no significant taxable temporary differences associated with investments in subsidiaries, branches, associates and joint arrangements.

28 Other provisions

The Group	Provisions for financial commitments and guarantees £m	Payment protection insurance £m	Other regulatory provisions £m	Other £m	Total £m
At 1 January 2020	55	596	232	94	977
Provisions applied	–	(475)	(230)	(30)	(735)
Charge for the year	74	(77)	184	98	279
At 31 December 2020	**129**	**44**	**186**	**162**	**521**

The Bank	Provisions for financial commitments and guarantees £m	Payment protection insurance £m	Other regulatory provisions £m	Other £m	Total £m
At 1 January 2020	55	594	225	94	968
Provisions applied	–	(471)	(225)	(29)	(725)
Charge for the year	74	(80)	186	96	276
At 31 December 2020	**129**	**43**	**186**	**161**	**519**

Provisions for financial commitments and guarantees
Provisions are recognised for expected credit losses on undrawn loan commitments and financial guarantees. See also note 15.

Payment protection insurance
The Group decreased the provision for PPI costs by £77 million in the year ended 31 December 2020, bringing the total amount provided to £6,344 million.

At 31 December 2020, a provision of £44 million remained unutilised relating to complaints and associated administration costs. Total cash payments were £475 million during the year ended 31 December 2020.

Other provisions for legal actions and regulatory matters
In the course of its business, the Group is engaged in discussions with the PRA, FCA and other UK and overseas regulators and other governmental authorities on a range of matters. The Group also receives complaints in connection with its past conduct and claims brought by or on behalf of current and former employees, customers, investors and other third parties and is subject to legal proceedings and other legal actions. Where significant, provisions are held against the costs expected to be incurred in relation to these matters and matters arising from related internal reviews. During the year ended 31 December 2020 the Group charged a further £184 million in respect of legal actions and other regulatory matters, and the unutilised balance at 31 December 2020 was £186 million (31 December 2019: £232 million). The most significant items are as follows.

Arrears handling related activities
The Group has provided an additional £19 million in the year ended 31 December 2020 for the costs of identifying and rectifying certain arrears management fees and activities, taking the total provided to date to £649 million. The Lloyds Banking Group has put in place a number of actions to improve its handling of customers in these areas and has made good progress in reimbursing arrears fees to impacted customers.

28 Other provisions (continued)

HBOS Reading – review

The Group completed its compensation assessment for those within the Customer Review in 2019 with more than £109 million of compensation paid, in addition to £15 million for ex-gratia payments and £6 million for the reimbursement of legal fees. The Group is applying the recommendations from Sir Ross Cranston's review, issued in December 2019, including a reassessment of direct and consequential losses by an independent panel, an extension of debt relief and a wider definition of de facto directors. Further details of the panel were announced on 3 April 2020 and the panel's full scope and methodology was published on 7 July 2020. The panel's stated objective is to consider cases via a non-legalistic and fair process, and to make their decisions in a generous, fair and common-sense manner. Details of an appeal process for the further assessments of debt relief and de facto director status have also been announced. The Group continues to make progress on its assessment of claims for further debt relief and de facto director status, completing preliminary assessments for 98 per cent of claims on both debt relief and de facto directors. As part of these activities the Group has recorded charges in relation to compensation payments and associated costs (projected to the fourth quarter of 2021) in 2020 in applying the recommendations, in respect of debt relief and de facto director status. During 2021, decisions from the independent panel re-review on direct and consequential losses will start to be issued, which is likely to result in further charges but it is not possible to estimate the potential impact at this stage. The Group is committed to implementing Sir Ross' recommendations in full.

The Dame Linda Dobbs review, which is considering the Group's handling of HBOS Reading between January 2009 and January 2017, is now expected to complete towards the end of 2021. The cost of undertaking the review is included in the revised provision.

The 2020 charge of £159 million, and lifetime cost of £435 million, includes both compensation payments and operational costs.

29 Subordinated liabilities

The movement in subordinated liabilities during the year was as follows:

The Group	Preference shares[1] £m	Preferred securities £m	Undated subordinated liabilities £m	Dated subordinated liabilities £m	Total £m
At 1 January 2019	–	321	4,596	1,858	6,775
Repurchases and redemptions during the year:[2]					
9.375% Subordinated Bonds 2021	–	–	–	(328)	(328)
6.375% Subordinated Instruments 2019	–	–	–	(250)	(250)
	–	–	–	(578)	(578)
Foreign exchange movements	–	–	(24)	–	(24)
Other movements (all non-cash)	–	2	(1)	(73)	(72)
At 31 December 2019	–	323	4,571	1,207	6,101
Issued during the year:					
SONIA 105 NC S.S. Subordinated Floating Rate Notes due 2026 (£1,000m)	**–**	**–**	**–**	**1,000**	**1,000**
Repurchases and redemptions during the year:[2]					
7.281% Perpetual Regulatory Tier One Securities (Series B) (£150 million)	**–**	**(154)**	**–**	**–**	**(154)**
Foreign exchange movements	**–**	**–**	**24**	**–**	**24**
Other movements (all non-cash)	**–**	**3**	**(2)**	**(8)**	**(7)**
At 31 December 2020	**–**	**172**	**4,593**	**2,199**	**6,964**

1 Since 2009, the Group has had in issue 400 6% non-cumulative preference shares of 25p each.

2 The repurchases and redemptions in the year resulted in cash outflows of £161 million (2019: £578 million).

29 Subordinated liabilities (continued)

The Bank	Preference shares[1] £m	Preferred securities £m	Undated subordinated liabilities £m	Dated subordinated liabilities £m	Total £m
At 1 January 2019	–	170	4,747	1,858	6,775
Repurchases and redemptions during the year:[2]					
9.375% Subordinated Bonds 2021	–	–	–	(328)	(328)
6.375% Subordinated Instruments 2019	–	–	–	(250)	(250)
	–	–	–	(578)	(578)
Foreign exchange movements	–	–	(24)	–	(24)
Other movements (all non-cash)	–	2	(1)	(73)	(72)
At 31 December 2019	–	172	4,722	1,207	6,101
Issued during the year:					
SONIA 105 NC S.S. Subordinated Floating Rate Notes due 2026 (£1,000m)	**–**	**–**	**–**	**1,000**	**1,000**
Repurchases and redemptions during the year:[2]					
7.281% Perpetual Regulatory Tier One Securities (Series B) (£150 million)	**–**	**(154)**	**–**	**–**	**(154)**
Foreign exchange movements	**–**	**–**	**24**	**–**	**24**
Other movements (all non-cash)	**–**	**3**	**(2)**	**(8)**	**(7)**
At 31 December 2020	**–**	**21**	**4,744**	**2,199**	**6,964**

1 The Bank has in issue 400 6% non-cumulative preference shares of 25p each.

2 The repurchases and redemptions in the year resulted in cash outflows of £161 million (2019: £578 million).

These securities will, in the event of the winding-up of the issuer, be subordinated to the claims of depositors and all other creditors of the issuer, other than creditors whose claims rank equally with, or are junior to, the claims of the holders of the subordinated liabilities. The subordination of specific subordinated liabilities is determined in respect of the issuer and any guarantors of that liability. The claims of holders of preference shares and preferred securities are generally junior to those of the holders of undated subordinated liabilities, which in turn are junior to the claims of holders of the dated subordinated liabilities. Neither the Group nor the Bank has had any defaults of principal, interest or other breaches with respect to its subordinated liabilities during 2020 (2019: none).

30 Share capital

(1) Authorised share capital	Group and Bank			
	2020 Number of shares	2019 Number of shares	**2020 £m**	2019 £m
Ordinary shares of 25p				
At 1 January and 31 December	**24,085,301,755**	24,085,301,755	**6,021**	6,021
8.117% non-cumulative perpetual preference shares class 'A' of £10 each	**250,000**	250,000	**3**	3
7.754% non-cumulative perpetual preference shares class 'B' of £10 each	**150,000**	150,000	**2**	2
			6,026	6,026

(2) Issued share capital	Group and Bank			
	2020 Number of shares	2019 Number of shares	**2020 £m**	2019 £m
Issued and fully paid ordinary shares				
Ordinary shares of 25p each				
At 1 January	**23,388,340,552**	23,388,340,552	**5,847**	5,847
Issued in the year	**1**	–	**–**	–
At 31 December	**23,388,340,553**	23,388,340,552	**5,847**	5,847
Issued and fully paid preference shares				
Preference shares of 25p each				
At 1 January and 31 December	**400**	400	**–**	–
Total share capital at 31 December	**23,388,340,953**	23,388,340,952	**5,847**	5,847

30 Share capital (continued)

Share capital and control
There are no limitations on voting rights or restrictions on the transfer of shares in the Bank other than as set out in the articles of association, and certain restrictions which may from time to time be imposed by law and regulations (for example, insider trading laws).

Ordinary shares
The holders of ordinary shares are entitled to receive the Bank's report and accounts, attend, speak and vote at general meetings and appoint proxies to exercise voting rights. Holders of ordinary shares may also receive a dividend (subject to the provisions of the Bank's articles of association) and on a winding up may share in the assets of the Bank.

31 Other reserves

	The Group		The Bank	
	2020 £m	2019 £m	**2020 £m**	2019 £m
Other reserves comprise:				
Merger and other reserves[1]	**1,600**	1,600	**1,600**	1,600
Capital redemption reserve[1]	**482**	482	**482**	482
Revaluation reserve in respect of debt securities held at fair value through other comprehensive income	**5**	(7)	**17**	6
Cash flow hedging reserve	**(45)**	(41)	**(45)**	(41)
Foreign currency translation reserve	**(22)**	(15)	**(8)**	–
At 31 December	**2,020**	2,019	**2,046**	2,047

1 There have been no movements in these reserves over 2019 or 2020.

Movements in other reserves were as follows:

	The Group		The Bank	
	2020 £m	2019 £m	**2020 £m**	2019 £m
Revaluation reserve in respect of debt securities held at fair value through other comprehensive income				
At 1 January	**(7)**	(11)	**6**	2
Change in fair value	**24**	5	**25**	5
Deferred tax	**(5)**	(1)	**(7)**	(1)
	19	4	**18**	4
Income statement transfers:				
Disposals (note 8)	**(10)**	–	**(10)**	–
Deferred tax	**3**	–	**3**	–
	(7)	–	**(7)**	–
At 31 December	**5**	(7)	**17**	6

31 Other reserves (continued)

	The Group and the Bank	
	2020 £m	2019 £m
Cash flow hedging reserve		
At 1 January	**(41)**	(70)
Change in fair value of hedging derivatives	**(3)**	2
Deferred tax	**2**	(1)
	(1)	1
Income statement transfers	**(4)**	37
Deferred tax	**1**	(9)
	(3)	28
At 31 December	**(45)**	(41)

	The Group		The Bank	
	2020 £m	2019 £m	**2020 £m**	2019 £m
Foreign currency translation reserve				
At 1 January	**(15)**	(109)	**–**	131
Currency translation differences arising in the year	**(7)**	(17)	**(8)**	(8)
Income statement transfers (tax: £nil)	**–**	111	**–**	(123)
At 31 December	**(22)**	(15)	**(8)**	–

32 Retained profits

	The Group		The Bank	
	2020 £m	2019 £m	**2020 £m**	2019 £m
At 1 January	**2,516**	2,373	**2,078**	1,860
Profit attributable to ordinary shareholders[1]	**749**	573	**751**	648
Dividends paid (note 34)	**–**	(500)	**–**	(500)
Post-retirement defined benefit scheme remeasurements (net of tax)	**15**	17	**15**	17
Capital contributions received	**33**	53	**33**	53
At 31 December	**3,313**	2,516	**2,877**	2,078

1 No income statement has been shown for the Bank, as permitted by Section 408 of the Companies Act 2006.

33 Other equity instruments

	The Group and Bank	
	2020 £m	2019 £m
At 1 January	**2,700**	1,500
Profit for the year attributable to other equity holders	**164**	101
Distributions on other equity instruments	**(164)**	(101)
Additional other equity instruments issued in the year	**1,000**	1,200
Redemption of other equity instruments	**(1,500)**	–
At 31 December	**2,200**	2,700

The Bank has in issue £2,200,000,000 of Additional Tier 1 (AT1) securities to Lloyds Bank plc. The AT1 securities are Fixed Rate Resetting Perpetual Subordinated Permanent Write-Down Securities with no fixed maturity or redemption date.

The principal terms of the AT1 securities are described below:

- The securities rank behind the claims against the Bank of unsubordinated creditors on a Winding-Up.
- The securities bear a fixed rate of interest until the first call date. After the initial call date, in the event that they are not redeemed, the AT1 securities will bear interest at rates fixed periodically in advance for five year periods based on the then prevailing reference rate plus initial spread.
- Interest on the securities will be due and payable only at the sole discretion of the Bank and the Bank may at any time elect to cancel any Interest Payment (or any part thereof) which would otherwise be payable on any Interest Payment Date. There are also certain restrictions on the payment of interest as specified in the terms.
- The securities are undated and are repayable, at the option of the Bank, in whole at the first call date, or at any Interest Payment date thereafter. In addition, the AT1 securities are repayable, at the option of the Bank, in whole for certain regulatory or tax reasons. Any repayments require the prior consent of the PRA.
- The securities will be subject to a Permanent Write Down should the fully Loaded Common Equity Tier 1 ratio of the Bank fall below 7.0 per cent.

34 Dividends on ordinary shares

Dividends paid during the year were as follows:

	2020 £m	2019 £m
Interim dividends	**–**	500

35 Share-based payments

During the year ended 31 December 2020 Lloyds Banking Group plc operated a number of share-based payment schemes for which employees of the Bank of Scotland Group were eligible and all of which are equity settled. Details of all schemes operated by Lloyds Banking Group are set out below; these are managed and operated on a Lloyds Banking Group-wide basis. The amount charged to the Group's income statement in respect of Lloyds Banking Group share-based payment schemes, and which is included within staff costs (note 9), was £48 million (2019: £78 million).

During the year ended 31 December 2020 the Lloyds Banking Group operated the following share-based payment schemes, all of which are equity settled.

Lloyds Banking Group Performance Share plan
The Lloyds Banking Group operates a Group Performance Share plan that is equity settled. No award has been made in respect of 2020; the charge in the year relates to prior year awards for which the deferral period has completed.

35 Share-based payments (continued)

Save-As-You-Earn schemes
Eligible employees may enter into contracts through the Save-As-You-Earn (SAYE) schemes to save up to £500 per month and, at the expiry of a fixed term of three years, have the option to use these savings within six months of the expiry of the fixed term to acquire shares in the Lloyds Banking Group at a discounted price of no less than 80 per cent (90 per cent for the 2020 plan) of the market price at the start of the invitation.

Movements in the number of share options outstanding under the SAYE schemes are set out below:

	2020		2019	
	Number of options	**Weighted average exercise price (pence)**	Number of options	Weighted average exercise price (pence)
Outstanding at 1 January	**1,068,094,073**	**44.55**	802,994,918	49.30
Granted	**779,229,797**	**24.25**	487,654,212	39.87
Exercised	**(255,706,663)**	**47.51**	(27,303,963)	51.23
Forfeited	**(6,938,102)**	**43.30**	(15,830,204)	48.69
Cancelled	**(389,767,675)**	**42.24**	(130,068,149)	49.03
Expired	**(74,772,515)**	**47.26**	(49,352,741)	58.74
Outstanding at 31 December	**1,120,138,915**	**30.39**	1,068,094,073	44.55
Exercisable at 31 December	**792,741**	**47.49**	227,139	60.70

TThe weighted average share price at the time that the options were exercised during 2020 was £0.61 (2019: £0.59). The weighted average remaining contractual life of options outstanding at the end of the year was 2.98 years (2019: 2.22 years).

The weighted average fair value of SAYE options granted during 2020 was £0.05 (2019: £0.10). The fair values of the SAYE options have been determined using a standard Black-Scholes model.

Other share option plans
Lloyds Banking Group Executive Share Plan 2003
The Plan was adopted in December 2003 and under the Plan share options may be granted to senior employees. Options under this plan have been granted specifically to facilitate recruitment (to compensate new recruits for any lost share awards), and also to make grants to key individuals for retention purposes. In some instances, grants may be made subject to individual performance conditions.

Participants are not entitled to any dividends paid during the vesting period.

	2020		2019	
	Number of options	**Weighted average exercise price (pence)**	Number of options	Weighted average exercise price (pence)
Outstanding at 1 January	**7,634,638**	**Nil**	10,263,028	Nil
Granted	**1,990,449**	**Nil**	2,336,171	Nil
Exercised	**(2,122,302)**	**Nil**	(4,455,481)	Nil
Vested	**(47,337)**	**Nil**	(69,005)	Nil
Forfeited	**(111,100)**	**Nil**	(39,250)	Nil
Lapsed	**(677,976)**	**Nil**	(400,825)	Nil
Outstanding at 31 December	**6,666,372**	**Nil**	7,634,638	Nil
Exercisable at 31 December	**3,150,407**	**Nil**	2,683,267	Nil

The weighted average fair value of options granted in the year was £0.33 (2019: £0.59). The fair values of options granted have been determined using a standard Black-Scholes model. The weighted average share price at the time that the options were exercised during 2020 was £0.36 (2019: £0.60). The weighted average remaining contractual life of options outstanding at the end of the year was 4.1 years (2019: 3.8 years).

35 Share-based payments (continued)

Other share plans

Lloyds Banking Group Executive Share Ownership Plan

The plan, introduced in 2006, is aimed at delivering shareholder value by linking the receipt of shares to an improvement in the performance of the Lloyds Banking Group over a three year period. Awards are made within limits set by the rules of the plan, with the limits determining the maximum number of shares that can be awarded equating to three times annual salary. In exceptional circumstances this may increase to four times annual salary.

At the end of the performance period for the 2017 grant, the targets had not been fully met and therefore these awards vested in 2020 at a rate of 49.7 per cent.

	2020 Number of shares	2019 Number of shares
Outstanding at 1 January	**459,904,745**	417,385,636
Granted	**211,214,605**	174,490,843
Vested	**(47,775,806)**	(88,318,950)
Forfeited	**(96,015,542)**	(55,029,439)
Dividend award	**6,659,525**	11,376,655
Outstanding at 31 December	**533,987,527**	459,904,745

Awards in respect of the 2018 grant vested in 2021 at a rate of 33.75 per cent. In previous years participants were entitled to any dividends paid in the vesting period. However, following a regulatory change prohibiting the payment of dividend equivalents on awards, the number of shares subject to award was determined by applying an adjustment factor to the share price on grant.

The weighted average fair value of awards granted in the year was £0.28 (2019: £0.45).

Chief Financial Officer Buyout

William Chalmers joined the Lloyds Banking Group on 3 June 2019 and was appointed as Chief Financial Officer on 1 August 2019 on the retirement of George Culmer. He was granted deferred share awards over 4,086,632 shares, to replace unvested awards from his former employer, Morgan Stanley, that were forfeited as a result of him joining the Lloyds Banking Group.

	2020 Number of shares	2019 Number of shares
Outstanding at 1 January	**3,268,460**	—
Granted	**—**	4,086,632
Exercised	**(1,457,748)**	(818,172)
Outstanding at 31 December	**1,810,712**	3,268,460

The weighted average fair value of awards granted in 2019 was £0.55.

The fair value calculations at 31 December 2020 for grants made in the year, using Black-Scholes models and Monte Carlo simulation, are based on the following assumptions:

	SAYE	**Executive Share Plan 2003**	**Executive Group Ownership Share Plan**
Weighted average risk-free interest rate	**(0.03%)**	**(0.01%)**	**0.18%**
Weighted average expected life	**3.2 years**	**1.2 years**	**3.6 years**
Weighted average expected volatility	**32%**	**42%**	**23%**
Weighted average expected dividend yield	**5.3%**	**5.3%**	**5.3%**
Weighted average share price	**£0.28**	**£0.35**	**£0.47**
Weighted average exercise price	**£0.24**	**Nil**	**Nil**

Expected volatility is a measure of the amount by which the Lloyds Banking Group's shares are expected to fluctuate during the life of an option. The expected volatility is estimated based on the historical volatility of the closing daily share price over the most recent period that is commensurate with the expected life of the option. The historical volatility is compared to the implied volatility generated from market traded options in the Lloyds Banking Group's shares to assess the reasonableness of the historical volatility and adjustments made where appropriate.

Share Incentive Plan

Free Shares

An award of shares may be made annually to employees up to a maximum of £3,600. The shares awarded are held in trust for a mandatory period of three years on the employee's behalf, during which period the employee is entitled to any dividends paid on such shares. The award is subject to a non-market based condition. If an employee leaves the Lloyds Banking Group within this three year period for other than a 'good' reason, all of the shares awarded will be forfeited.

On 20 May 2020, the Lloyds Banking Group made an award of £200 (2019: £200) of shares to all eligible employees. The number of shares awarded was 45,612,424 (2019: 22,422,337), with an average fair value of £0.30 (2019: £0.62) based on the market price at the date of award.

35 Share-based payments (continued)

Matching shares

The Lloyds Banking Group undertakes to match shares purchased by employees up to the value of £45 per month; these matching shares are held in trust for a mandatory period of three years on the employee's behalf, during which period the employee is entitled to any dividends paid on such shares. The award is subject to a non-market based condition: if an employee leaves within this three year period for other than a 'good' reason, all of the matching shares are forfeited. Similarly if the employees sell their purchased shares within three years, their matching shares are forfeited.

The number of shares awarded relating to matching shares in 2020 was 62,262,140 (2019: 37,346,812), with an average fair value of £0.34 (2019: £0.56), based on market prices at the date of award.

Fixed share awards

Fixed share awards were introduced in 2014 in order to ensure that total fixed remuneration is commensurate with role and to provide a competitive reward package for certain Lloyds Banking Group employees, with an appropriate balance of fixed and variable remuneration, in line with regulatory requirements. The fixed share awards are delivered in Lloyds Banking Group shares, released over five years with 20 per cent being released each year following the year of award. From June 2020, the fixed share awards are released over three years with one third being released each year following the year of award. The number of shares purchased in 2020 was 13,975,993 (2019: 8,239,332).

The fixed share award is not subject to any performance conditions, performance adjustment or clawback. On an employee leaving the Lloyds Banking Group, there is no change to the timeline for which shares will become unrestricted.

36 Related party transactions

Key management personnel

Key management personnel are those persons having authority and responsibility for planning, directing and controlling the activities of an entity; the Group's key management personnel are the members of the Lloyds Banking Group plc Group Executive Committee together with its Non-Executive Directors.

The table below details, on an aggregated basis, key management personnel compensation which has been allocated to the Bank on an estimated basis.

	2020 £m	2019 £m
Compensation		
Salaries and other short-term benefits	5	6
Share-based payments	5	6
Total compensation	10	12

The aggregate of the emoluments of the directors was £4.7 million (2019: £4.7 million).

Aggregate company contributions in respect of directors to defined contribution pension schemes were £nil (2019: £nil).

The total for the highest paid director (Juan Colimbás) was £1,668,000 (2019: (António Horta-Osório) £1,631,000); this did not include any gain on exercise of Lloyds Banking Group plc shares in either year.

	2020 million	2019 million
Share incentive plans settled in Lloyds Banking Group plc shares		
At 1 January	101	84
Granted (includes entitlements of appointed key management personnel)	46	46
Exercised/lapsed (includes entitlements of former key management personnel)	(30)	(29)
At 31 December	117	101

36 Related party transactions (continued)

The tables below detail, on an aggregated basis, balances outstanding at the year end and related income and expense, together with information relating to other transactions between Lloyds Banking Group and its key management personnel:

	2020 £m	2019 £m
Loans		
At 1 January	**2**	2
Advanced (includes loans of appointed key management personnel)	**–**	1
Repayments (includes loans of former key management personnel)	**–**	(1)
At 31 December	**2**	2

The loans are on both a secured and unsecured basis and are expected to be settled in cash. The loans attracted interest rates of between 0.39 per cent and 24.20 per cent in 2020 (6.45 per cent and 24.20 per cent in 2019).

No provisions have been recognised in respect of loans given to key management personnel (2019: nil).

	2020 £m	2019 £m
Deposits		
At 1 January	**23**	20
Placed (includes deposits of appointed key management personnel)	**26**	44
Withdrawn (includes deposits of former key management personnel)	**(38)**	(41)
At 31 December	**11**	23

Deposits placed by key management personnel attracted interest rates of up to 2 per cent in 2020 (2019: 3 per cent). At 31 December 2020, the Group did not provide any guarantees in respect of key management personnel (2019: none).

At 31 December 2020, transactions, arrangements and agreements entered into by the Lloyds Banking Group's banking subsidiaries with directors and connected persons of the Group included amounts outstanding in respect of loans and credit card transactions of £0.6 million with five directors and two connected persons (2019: £0.6 million with five directors and two connected persons).

Balances and transactions with fellow Lloyds Banking Group undertakings
Transfers of operations
During 2019, the Bank transferred the majority of its Netherlands and Germany business to Lloyds Bank Gmbh, a fellow Lloyds Banking Group undertaking.

Balances and transactions between members of the Bank of Scotland Group
In accordance with IFRS10 *Consolidated Financial Statements*, transactions and balances between the Bank and its subsidiary undertakings, and between those subsidiary undertakings, have all been eliminated on consolidation and thus are not reported as related party transactions of the Group.

The Bank, as a result of its position as parent of a banking group, has a large number of transactions with various of its subsidiary undertakings; these are included on the balance sheet of the Bank as follows:

	2020 £m	2019 £m
Assets, included within:		
Due from fellow Lloyds Banking Group undertakings	**9,826**	11,490
Derivated financial instruments	**7**	–
Liabilities, included within:		
Due to fellow Lloyds Banking Group undertakings	**7,948**	8,285
Derivated financial instruments	**2**	–
Debt securities in issue	**1,704**	4,066
Subordinated liabilities	**151**	151

Due to the size and volume of transactions passing through these accounts, it is neither practical nor meaningful to disclose information on gross inflows and outflows. During 2020 the Bank earned interest income on the above asset balances of £97 million (2019: £172 million) and incurred interest expense on the above liability balances of £105 million (2019: £166 million).

36 Related party transactions (continued)

Balances and transactions with Lloyds Banking Group plc and fellow subsidiaries of the Lloyds Banking Group
The Bank and its subsidiaries have balances due to and from the Bank's ultimate parent company, Lloyds Banking Group plc and fellow subsidiaries of the Lloyds Banking Group. These are included on the balance sheet as follows:

	The Group		The Bank	
	2020 £m	2019 £m	**2020 £m**	2019 £m
Assets, included within:				
Derivative financial instruments	**4,819**	7,026	**4,820**	7,026
Due from fellow Lloyds Banking Group undertakings	**28,988**	97,534	**28,900**	97,445

	The Group		The Bank	
	2020 £m	2019 £m	**2020 £m**	2019 £m
Liabilities, included within:				
Due to fellow Lloyds Banking Group undertakings	**91,953**	161,618	**91,664**	161,528
Derivative financial instruments	**7,374**	9,107	**7,374**	9,107
Subordinated liabilities	**6,512**	5,502	**6,512**	5,502
Debt securities in issue	**1,215**	45	**1,186**	5

Due to the size and volume of transactions passing through these accounts, it is neither practical nor meaningful to disclose information on gross inflows and outflows. During 2020 the Group earned £340 million and the Bank earned £340 million of interest income on the above asset balances (2019: £613 million for the Group and £613 million for the Bank); the Group incurred £1,882 million and the Bank incurred £1,881 million of interest expense on the above liability balances (2019: £2,252 million for the Group and £2,250 million for the Bank).

Other related party disclosures
Pension funds
At 31 December 2020 there were customer deposits of £43 million (2019: £50 million) related to the HBOS Group's pension arrangements.

Joint ventures and associates
At 31 December 2020 there were loans and advances to customers of £11 million (2019: £67 million) outstanding and balances within customer deposits of £4 million (2019: £3 million) relating to joint ventures and associates.

37 Contingent liabilities, commitments and guarantees

Where appropriate, the following discussion covers the Lloyds Banking Group as a whole.

Interchange fees
With respect to multi-lateral interchange fees (MIFs), the Lloyds Banking Group is not involved in the ongoing litigation which involves card schemes such as Visa and Mastercard (as described below). However, the Lloyds Banking Group is a member/licensee of Visa and Mastercard and other card schemes. The litigation in question is as follows:

– litigation brought by retailers against both Visa and Mastercard continues in the English Courts (and includes a judgment of the Supreme Court in June 2020 upholding the Court of Appeal's finding in 2018 that historic interchange arrangements of Mastercard and Visa infringed competition law); and
– litigation brought on behalf of UK consumers in the English Courts against Mastercard, which the Supreme Court has now confirmed can proceed.

Any impact on the Lloyds Banking Group of the litigation against Visa and Mastercard remains uncertain at this time, such that it is not practicable for the Group to provide an estimate of any potential financial effect. Insofar as Visa is required to pay damages to retailers for interchange fees set prior to June 2016, contractual arrangements to allocate liability have been agreed between various UK banks (including the Lloyds Banking Group) and Visa Inc, as part of Visa Inc's acquisition of Visa Europe in 2016. These arrangements cap the maximum amount of liability to which the Lloyds Banking Group may be subject and this cap is set at the cash consideration received by the Lloyds Banking Group for the sale of its stake in Visa Europe to Visa Inc in 2016. In 2016, the Lloyds Banking Group received Visa preference stock as part of the consideration for the sale of its shares in Visa Europe. In 2020, some of these Visa preference shares were converted into Visa Inc Class A common stock (in accordance with the provisions of the Visa Europe sale documentation) and they were subsequently sold by the Lloyds Banking Group. The sale had no impact on this contingent liability.

LIBOR and other trading rates
Certain Lloyds Banking Group companies, together with other panel banks, have been named as defendants in private lawsuits, including purported class action suits, in the US in connection with their roles as panel banks contributing to the setting of US Dollar, Japanese Yen and Sterling London Interbank Offered Rate and the Australian BBSW reference rate. Certain of the plaintiffs' claims have been dismissed by the US Federal Court for the Southern District of New York (subject to appeals).

Certain Lloyds Banking Group companies are also named as defendants in (i) UK based claims; and (ii) two Dutch class actions, raising LIBOR manipulation allegations. A number of the claims against the Lloyds Banking Group in relation to the alleged mis-sale of interest rate hedging products also include allegations of LIBOR manipulation.

Furthermore, the Swiss Competition Commission concluded its investigation against Lloyds Bank plc in June 2019. However, the Lloyds Banking Group continues to respond to litigation arising out of the investigations into submissions made by panel members to the bodies that set LIBOR and various other interbank offered rates.

37 Contingent liabilities, commitments and guarantees (continued)

It is currently not possible to predict the scope and ultimate outcome on the Lloyds Banking Group of the various outstanding regulatory investigations not encompassed by the settlements, any private lawsuits or any related challenges to the interpretation or validity of any of the Lloyds Banking Group's contractual arrangements, including their timing and scale. As such, it is not practicable to provide an estimate of any potential financial effect.

Tax authorities

The Lloyds Banking Group has an open matter in relation to a claim for group relief of losses incurred in its former Irish banking subsidiary, which ceased trading on 31 December 2010. In 2013, HMRC informed the Lloyds Banking Group that its interpretation of the UK rules means that the group relief is not available. In 2020, HMRC concluded their enquiry into the matter and issued a closure notice. The Lloyds Banking Group's interpretation of the UK rules has not changed and hence it has appealed to the First Tier Tax Tribunal, with a hearing expected in early 2022. If the final determination of the matter by the judicial process is that HMRC's position is correct, management estimate that this would result in an increase in the Group's current tax liabilities of approximately £175 million (including interest). The Lloyds Banking Group, having taken appropriate advice, does not consider that this is a case where additional tax will ultimately fall due.

There are a number of other open matters on which the Lloyds Banking Group is in discussions with HMRC (including the tax treatment of certain costs arising from the divestment of TSB Banking Group plc), none of which is expected to have a material impact on the financial position of the Group.

Other legal actions and regulatory matters

In addition, during the ordinary course of business the Group is subject to other complaints and threatened or actual legal proceedings (including class or group action claims) brought by or on behalf of current or former employees, customers, investors or other third parties, as well as legal and regulatory reviews, challenges, investigations and enforcement actions, both in the UK and overseas. All material such matters are periodically reassessed, with the assistance of external professional advisers where appropriate, to determine the likelihood of the Group incurring a liability. In those instances where it is concluded that it is more likely than not that a payment will be made, a provision is established to management's best estimate of the amount required at the relevant balance sheet date. In some cases it will not be possible to form a view, for example because the facts are unclear or because further time is needed properly to assess the merits of the case, and no provisions are held in relation to such matters. In these circumstances, specific disclosure in relation to a contingent liability will be made where material. However the Group does not currently expect the final outcome of any such case to have a material adverse effect on its financial position, operations or cash flows.

Contingent liabilities, commitments and guarantees arising from the banking business

	The Group and the Bank	
	2020 £m	2019 £m
Contingent liabilities		
Acceptances and endorsements	–	1
Other:		
Other items serving as direct credit substitutes	**18**	20
Performance bonds and other transaction-related contingencies	**189**	199
	207	219
Total contingent liabilities	**207**	220

37 Contingent liabilities, commitments and guarantees (continued)

The contingent liabilities of the Group, as detailed above, arise in the normal course of its banking business and it is not practicable to quantify their future financial effect.

	The Group		The Bank	
	2020 £m	2019 £m	**2020 £m**	2019 £m
Commitments and guarantees				
Documentary credits and other short-term trade-related transactions	**1**	–	**1**	–
Forward asset purchases and forward deposits placed	**28**	14	**28**	14
Undrawn formal standby facilities, credit lines and other commitments to lend:				
Less than 1 year original maturity:				
Mortgage offers made	**17,828**	11,271	**17,705**	11,143
Other commitments and guarantees	**26,203**	24,217	**26,162**	24,176
	44,031	35,488	**43,867**	35,319
1 year or over original maturity	**3,512**	2,410	**3,512**	2,410
Total commitments and guarantees	**47,572**	37,912	**47,408**	37,743

Of the amounts shown above in respect of undrawn formal standby facilities, credit lines and other commitments to lend, £20,919 million (2019: £14,478 million) for the Group and £20,796 million (2019: £14,383 million) for the Bank were irrevocable.

Capital commitments
Excluding commitments of the Group in respect of investment property (note 20), there was no capital expenditure contracted but not provided for at 31 December 2020 (2019: £nil).

38 Structured entities

The Group's interests in structured entities are consolidated. Details of the Group's interest in consolidated structured entities are set out in note 25 for securitisations and covered bond vehicles.

39 Financial instruments

(1) Measurement basis of financial assets and liabilities

The accounting policies in note 2 describe how different classes of financial instruments are measured, and how income and expenses, including fair value gains and losses, are recognised. The following table analyses the carrying amounts of the financial assets and liabilities by category and by balance sheet heading.

The Group	Derivatives designated as hedging instruments £m	Mandatorily held at fair value through profit or loss: Held for trading £m	Mandatorily held at fair value through profit or loss: Other £m	Designated at fair value through profit or loss £m	At fair value through other comprehensive income £m	Held at amortised cost £m	Total £m
At 31 December 2020							
Financial assets							
Cash and balances at central banks	–	–	–	–	–	2,841	2,841
Items in the course of collection from banks	–	–	–	–	–	42	42
Financial assets at fair value through profit or loss	–	–	477	–	–	–	477
Derivative financial instruments	1,285	6,138	–	–	–	–	7,423
Loans and advances to banks	–	–	–	–	–	207	207
Loans and advances to customers	–	–	–	–	–	263,766	263,766
Due from fellow Lloyds Banking Group undertakings	–	–	–	–	–	28,988	28,988
Financial assets at amortised cost	–	–	–	–	–	292,961	292,961
Financial assets at fair value through other comprehensive income	–	–	–	–	2,395	–	2,395
Total financial assets	1,285	6,138	477	–	2,395	295,844	306,139
Financial liabilities							
Deposits from banks	–	–	–	–	–	14,695	14,695
Customer deposits	–	–	–	–	–	163,001	163,001
Due to fellow Lloyds Banking Group undertakings	–	–	–	–	–	91,953	91,953
Items in course of transmission to banks	–	–	–	–	–	98	98
Financial liabilities at fair value through profit or loss	–	–	–	45	–	–	45
Derivative financial instruments	998	7,674	–	–	–	–	8,672
Notes in circulation	–	–	–	–	–	1,305	1,305
Debt securities in issue	–	–	–	–	–	8,297	8,297
Other liabilities	–	–	–	–	–	699	699
Subordinated liabilities	–	–	–	–	–	6,964	6,964
Total financial liabilities	998	7,674	–	45	–	287,012	295,729

39 Financial instruments (continued)

The Group	Derivatives designated as hedging instruments £m	Mandatorily held at fair value through profit or loss: Held for trading £m	Mandatorily held at fair value through profit or loss: Other £m	Designated at fair value through profit or loss £m	At fair value through other comprehensive income £m	Held at amortised cost £m	Total £m
At 31 December 2019							
Financial assets							
Cash and balances at central banks	–	–	–	–	–	2,492	2,492
Items in the course of collection from banks	–	–	–	–	–	40	40
Financial assets at fair value through profit or loss	–	–	463	–	–	–	463
Derivative financial instruments	1,523	8,815	–	–	–	–	10,338
Loans and advances to banks	–	–	–	–	–	311	311
Loans and advances to customers	–	–	–	–	–	258,315	258,315
Due from fellow Lloyds Banking Group undertakings	–	–	–	–	–	97,534	97,534
Financial assets at amortised cost	–	–	–	–	–	356,160	356,160
Financial assets at fair value through other comprehensive income	–	–	–	–	2,253	–	2,253
Total financial assets	1,523	8,815	463	–	2,253	358,692	371,746
Financial liabilities							
Deposits from banks	–	–	–	–	–	16,472	16,472
Customer deposits	–	–	–	–	–	151,845	151,845
Due to fellow Lloyds Banking Group undertakings	–	–	–	–	–	161,618	161,618
Items in course of transmission to banks	–	–	–	–	–	143	143
Financial liabilities at fair value through profit or loss	–	–	–	47	–	–	47
Derivative financial instruments	996	10,356	–	–	–	–	11,352
Notes in circulation	–	–	–	–	–	1,079	1,079
Debt securities in issue	–	–	–	–	–	11,204	11,204
Other liabilities	–	–	–	–	–	770	770
Subordinated liabilities	–	–	–	–	–	6,101	6,101
Total financial liabilities	996	10,356	–	47	–	349,232	360,631

39 Financial instruments (continued)

The Bank	Derivatives designated as hedging instruments £m	Mandatorily held at fair value through profit or loss: Held for trading £m	Mandatorily held at fair value through profit or loss: Other £m	Designated at fair value through profit or loss £m	At fair value through other comprehensive income £m	Held at amortised cost £m	Total £m
At 31 December 2020							
Financial assets							
Cash and balances at central banks	–	–	–	–	–	2,841	2,841
Items in the course of collection from banks	–	–	–	–	–	42	42
Financial assets at fair value through profit or loss	–	–	158	–	–	–	158
Derivative financial instruments	1,248	6,175	–	–	–	–	7,423
Loans and advances to banks	–	–	–	–	–	205	205
Loans and advances to customers	–	–	–	–	–	259,697	259,697
Due from fellow Lloyds Banking Group undertakings	–	–	–	–	–	38,726	38,726
Financial assets at amortised cost	–	–	–	–	–	298,628	298,628
Financial assets at fair value through other comprehensive income	–	–	–	–	2,395	–	2,395
Total financial assets	1,248	6,175	158	–	2,395	301,511	311,487
Financial liabilities							
Deposits from banks	–	–	–	–	–	14,694	14,694
Customer deposits	–	–	–	–	–	163,000	163,000
Due to fellow Lloyds Banking Group undertakings	–	–	–	–	–	99,612	99,612
Items in course of transmission to banks	–	–	–	–	–	98	98
Derivative financial instruments	977	7,383	–	–	–	–	8,360
Notes in circulation	–	–	–	–	–	1,305	1,305
Debt securities in issue	–	–	–	–	–	7,012	7,012
Other liabilities	–	–	–	–	–	699	699
Subordinated liabilities	–	–	–	–	–	6,964	6,964
Total financial liabilities	977	7,383	–	–	–	293,384	301,744

39 Financial instruments (continued)

The Bank	Derivatives designated as hedging instruments £m	Mandatorily held at fair value through profit or loss		Designated at fair value through profit or loss £m	At fair value through other comprehensive income £m	Held at amortised cost £m	Total £m
		Held for trading £m	Other £m				
At 31 December 2019							
Financial assets							
Cash and balances at central banks	–	–	–	–	–	2,492	2,492
Items in the course of collection from banks	–	–	–	–	–	40	40
Financial assets at fair value through profit or loss	–	–	117	–	–	–	117
Derivative financial instruments	1,523	8,773	–	–	–	–	10,296
Loans and advances to banks	–	–	–	–	–	307	307
Loans and advances to customers	–	–	–	–	–	252,931	252,931
Due from fellow Lloyds Banking Group undertakings	–	–	–	–	–	108,935	108,935
Financial assets at amortised cost	–	–	–	–	–	362,173	362,173
Financial assets at fair value through other comprehensive income	–	–	–	–	2,253	–	2,253
Total financial assets	1,523	8,773	117	–	2,253	364,705	377,371
Financial liabilities							
Deposits from banks	–	–	–	–	–	16,472	16,472
Customer deposits	–	–	–	–	–	151,818	151,818
Due to fellow Lloyds Banking Group undertakings	–	–	–	–	–	169,813	169,813
Items in course of transmission to banks	–	–	–	–	–	143	143
Derivative financial instruments	996	10,052	–	–	–	–	11,048
Notes in circulation	–	–	–	–	–	1,079	1,079
Debt securities in issue	–	–	–	–	–	9,700	9,700
Other liabilities	–	–	–	–	–	770	770
Subordinated liabilities	–	–	–	–	–	6,101	6,101
Total financial liabilities	996	10,052	–	–	–	355,896	366,944

39 Financial instruments (continued)

(2) Fair value measurement
Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. It is a measure as at a specific date and may be significantly different from the amount which will actually be paid or received on maturity or settlement date.

Wherever possible, fair values have been calculated using unadjusted quoted market prices in active markets for identical instruments held by the Group. Where quoted market prices are not available, or are unreliable because of poor liquidity, fair values have been determined using valuation techniques which, to the extent possible, use market observable inputs, but in some cases use non-market observable inputs. Valuation techniques used include discounted cash flow analysis and pricing models and, where appropriate, comparison to instruments with characteristics similar to those of the instruments held by the Group. The Group measures valuation adjustments for its derivative exposures on the same basis as derivatives are managed.

The carrying amount of the following financial instruments is a reasonable approximation of fair value: cash and balances at central banks, items in the course of collection from banks, items in course of transmission to banks and notes in circulation.

Because a variety of estimation techniques are employed and significant estimates made, comparisons of fair values between financial institutions may not be meaningful. Readers of these financial statements are thus advised to use caution when using this data to evaluate the Group's financial position.

Fair value information is not provided for items that are not financial instruments or for other assets and liabilities which are not carried at fair value in the Group's consolidated balance sheet. These items include intangible assets; premises and equipment; and shareholders' equity. These items are material and accordingly the Group believes that any fair value information presented would not represent the underlying value of the Group.

Valuation control framework
The key elements of the control framework for the valuation of financial instruments include model validation, product implementation review and independent price verification. These functions are carried out by appropriately skilled risk and finance teams, independent of the business area responsible for the products.

Model validation covers both qualitative and quantitative elements relating to new models. In respect of new products, a product implementation review is conducted pre- and post-trading. Pre-trade testing ensures that the new model is integrated into the Group's systems and that the profit and loss and risk reporting are consistent throughout the trade life cycle. Post-trade testing examines the explanatory power of the implemented model, actively monitoring model parameters and comparing in-house pricing to external sources. Independent price verification procedures cover financial instruments carried at fair value. The frequency of the review is matched to the availability of independent data, monthly being the minimum. Valuation differences in breach of established thresholds are escalated to senior management. The results from independent pricing and valuation reserves are reviewed monthly by senior management.

Formal committees, consisting of senior risk, finance and business management, meet at least quarterly to discuss and approve valuations in more judgemental areas, in particular for unquoted equities, structured credit, over-the-counter options and the Credit Valuation Adjustment (CVA) reserve.

Valuation of financial assets and liabilities
Assets and liabilities carried at fair value or for which fair values are disclosed have been classified into three levels according to the quality and reliability of information used to determine the fair values.

Level 1
Level 1 fair value measurements are those derived from unadjusted quoted prices in active markets for identical assets or liabilities. Products classified as level 1 predominantly comprise equity shares, treasury bills and other government securities.

Level 2
Level 2 valuations are those where quoted market prices are not available, for example where the instrument is traded in a market that is not considered to be active or valuation techniques are used to determine fair value and where these techniques use inputs that are based significantly on observable market data. Examples of such financial instruments include most over-the-counter derivatives, financial institution issued securities, certificates of deposit and certain asset-backed securities.

Level 3
Level 3 portfolios are those where at least one input which could have a significant effect on the instrument's valuation is not based on observable market data. Such instruments would include unlisted equity investments which are valued using various valuation techniques that require significant management judgement in determining appropriate assumptions, including earnings multiples and estimated future cash flows. Certain of the Group's asset-backed securities and derivatives, principally where there is no trading activity in such securities, are also classified as level 3.

Transfers out of the level 3 portfolio arise when inputs that could have a significant impact on the instrument's valuation become market observable after previously having been non-market observable. In the case of asset-backed securities this can arise if more than one consistent independent source of data becomes available. Conversely transfers into the portfolio arise when consistent sources of data cease to be available.

39 Financial instruments (continued)

(3) Financial assets and liabilities carried at fair value
(A) Financial assets, excluding derivatives
Valuation hierarchy
At 31 December 2020 the Group's financial assets carried at fair value, excluding derivatives, totalled £2,872 million (31 December 2019: £2,716 million); and for the Bank totalled £2,553 million (31 December 2019: £2,370 million). The tables below analyse these financial assets by balance sheet classification, asset type and valuation methodology (level 1, 2 or 3, as described on page 88). The fair value measurement approach is recurring in nature. There were no significant transfers between level 1 and 2 during the year.

Valuation hierarchy

The Group At 31 December 2020	**Level 1 £m**	**Level 2 £m**	**Level 3 £m**	**Total £m**
Financial assets at fair value through profit or loss:				
Loans and advances to customers	**–**	**–**	**477**	**477**
Financial assets at fair value through other comprehensive income:				
Corporate and other debt securities	**–**	**2,395**	**–**	**2,395**
Total financial assets carried at fair value, excluding derivatives	**–**	**2,395**	**477**	**2,872**

The Group At 31 December 2019	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Financial assets at fair value through profit or loss:				
Loans and advances to customers	–	–	463	463
Financial assets at fair value through other comprehensive income:				
Corporate and other debt securities	–	2,253	–	2,253
Total financial assets carried at fair value, excluding derivatives	–	2,253	463	2,716

39 Financial instruments (continued)

Valuation hierarchy

The Bank	**Level 1 £m**	**Level 2 £m**	**Level 3 £m**	**Total £m**
At 31 December 2020				
Financial assets at fair value through profit or loss:				
Loans and advances to customers	**–**	**–**	**158**	**158**
Financial assets at fair value through other comprehensive income:				
Corporate and other debt securities	**–**	**2,395**	**–**	**2,395**
Total financial assets carried at fair value, excluding derivatives	**–**	**2,395**	**158**	**2,553**

Valuation hierarchy

The Bank	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
At 31 December 2019				
Financial assets at fair value through profit or loss:				
Loans and advances to customers	–	–	117	117
Financial assets at fair value through other comprehensive income:				
Corporate and other debt securities	–	2,253	–	2,253
Total financial assets carried at fair value, excluding derivatives	–	2,253	117	2,370

39 Financial instruments (continued)

Movements in level 3 portfolio

The table below analyses movements in level 3 financial assets, excluding derivatives, carried at fair value (recurring measurement):

The Group	2020 £m	2019 £m
At 1 January	463	110
Gains recognised in the income statement within other income	16	3
Purchases	25	–
Sales	(27)	(57)
Transfers into the level 3 portfolio	–	407
At 31 December	477	463
Gains recognised in the income statement, within other income, relating to the change in fair value of those assets held at 31 December	15	–

The Bank	2020 £m	2019 £m
At 1 January	117	110
Gains (losses) recognised in the income statement within other income	21	3
Purchases	25	–
Sales	(5)	(4)
Transfers into the level 3 portfolio	–	8
At 31 December	158	117
Gains recognised in the income statement, within other income, relating to the change in fair value of those assets held at 31 December	15	–

39 Financial instruments (continued)

Valuation methodology for financial assets, excluding derivatives

Loans and advances to customers and banks
The fair value of these assets is determined using discounted cash flow techniques. The discount rates are derived from market observable interest rates, a risk margin that reflects loan credit ratings and an incremental illiquidity premium based on historical spreads at origination on similar loans.

Debt securities
Debt securities measured at fair value and classified as level 2 are valued by discounting expected cash flows using an observable credit spread applicable to the particular instrument.

Where there is limited trading activity in debt securities, the Group uses valuation models, consensus pricing information from third party pricing services and broker or lead manager quotes to determine an appropriate valuation. Debt securities are classified as level 3 if there is a significant valuation input that cannot be corroborated through market sources or where there are materially inconsistent values for an input. Asset classes classified as level 3 mainly comprise certain collateralised loan obligations and collateralised debt obligations.

(B) Financial liabilities, excluding derivatives
Valuation hierarchy
At 31 December 2020, the Group's financial liabilities carried at fair value, excluding derivatives, comprised its financial liabilities at fair value through profit or loss and totalled £45 million (31 December 2019: £47 million); and for the Bank totalled £nil (31 December 2019: £nil) (Financial guarantees are also recognised at fair value, on initial recognition, and are classified as level 3; but the balance is not material). The tables below analyse these financial liabilities by balance sheet classification and valuation methodology (level 1, 2 or 3, as described on page 88). The fair value measurement approach is recurring in nature. There were no significant transfers between level 1 and 2 during the year.

The Group	**Level 1 £m**	**Level 2 £m**	**Level 3 £m**	**Total £m**
At 31 December 2020				
Financial liabilities designated at fair value through profit or loss	**–**	**–**	**45**	**45**
At 31 December 2019				
Financial liabilities designated at fair value through profit or loss	–	–	47	47

39 Financial instruments (continued)

The table below analyses movements in level 3 financial liabilities, excluding derivatives:

Group	2020 £m	2019 £m
At 1 January	**47**	–
Losses recognised in the income statement within other income	**1**	1
Redemptions	**(3)**	(5)
Transfers into the level 3 portfolio	**–**	51
At 31 December	**45**	47
Losses recognised in the income statement, within other income, relating to the change in fair value of those liabilities held at 31 December	**1**	**1**

Valuation methodology for financial liabilities, excluding derivatives

Trading liabilities in respect of securities sold under repurchase agreements

The fair value of these liabilities is determined using discounted cash flow techniques. The discount rates are derived from observable repo curves specific to the type of security sold under the repurchase agreement.

39 Financial instruments (continued)

(C) Derivatives

All of the Group's derivative assets and liabilities are carried at fair value. At 31 December 2020, such assets totalled £7,423 million for the Group and £7,423 million for the Bank (31 December 2019: £10,338 million for the Group and £10,296 million for the Bank) and liabilities totalled £8,672 million for the Group and £8,360 million for the Bank (31 December 2019: £11,352 million for the Group and £11,048 million for the Bank). The table below analyses these derivative balances by valuation methodology (level 1, 2 or 3, as described on page 88). The fair value measurement approach is recurring in nature. There were no significant transfers between level 1 and level 2 during the year.

The Group	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
At 31 December 2020				
Derivative assets	**–**	**7,411**	**12**	**7,423**
Derivative liabilities	**–**	**8,401**	**271**	**8,672**
At 31 December 2019				
Derivative assets	–	10,338	–	10,338
Derivative liabilities	–	11,055	297	11,352

The Bank	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
At 31 December 2020				
Derivative assets	**–**	**7,411**	**12**	**7,423**
Derivative liabilities	**–**	**8,360**	**–**	**8,360**
At 31 December 2019				
Derivative assets	–	10,296	–	10,296
Derivative liabilities	–	11,048	–	11,048

Where the Group's derivative assets and liabilities are not traded on an exchange, they are valued using valuation techniques, including discounted cash flow and options pricing models, as appropriate. The types of derivatives classified as level 2 and the valuation techniques used include:

- Interest rate swaps which are valued using discounted cash flow models; the most significant inputs into those models are interest rate yield curves which are developed from publicly quoted rates.
- Foreign exchange derivatives that do not contain options which are priced using rates available from publicly quoted sources.
- Credit derivatives which are valued using standard models with observable inputs, except for the items classified as level 3, which are valued using publicly available yield and credit default swap (CDS) curves.
- Less complex interest rate and foreign exchange option products which are valued using volatility surfaces developed from publicly available interest rate cap, interest rate swaption and other option volatilities; option volatility skew information is derived from a market standard consensus pricing service. For more complex option products, the Group calibrates its models using observable at-the-money data; where necessary, the Group adjusts for out-of-the-money positions using a market standard consensus pricing service.

Complex interest rate and foreign exchange products where inputs to the valuation are significant and unobservable are classified as level 3.

Where credit protection, usually in the form of credit default swaps, has been purchased or written on asset-backed securities, the security is referred to as a negative basis asset-backed security and the resulting derivative assets or liabilities have been classified as either level 2 or level 3 according to the classification of the underlying asset-backed security.

Certain unobservable inputs used to calculate CVA, FVA, and own credit adjustments, are not significant in determining the classification of the derivative and debt instruments. Consequently these inputs do not form part of the Level 3 sensitivities presented.

39 Financial instruments (continued)

The below table analyses movements in level 3 derivative assets.

The Group and the Bank	2020 £m	2019 £m
At 1 January	–	–
Transfers into the level 3 portfolio	11	–
Gains recognised in the income statement	1	–
At 31 December	**12**	–
Gains recognised in the income statement, within other income, relating to the change in fair value of those assets held at 31 December	1	–

The table below analyses movements in level 3 derivative liabilities.

The Group	2020 £m	2019 £m
At 1 January	(297)	–
Transfers into the level 3 portfolio	(1)	–
Gains recognised in the income statement	7	–
Redemptions	20	47
Transfers into the level 3 portfolio	–	(344)
At 31 December	**(271)**	(297)
Gains (losses) recognised in the income statement, within other income, relating to the change in fair value of those assets or liabilities held at 31 December	7	–

Derivative valuation adjustments

Derivative financial instruments which are carried in the balance sheet at fair value are adjusted where appropriate to reflect credit risk, market liquidity and other risks.

(i) Uncollateralised derivative valuation adjustments

The following table summarises the movement on this valuation adjustment account for the Group during 2020 and 2019.

	2020 £m	2019 £m
At 1 January	102	140
Income statement charge (credit)	18	(36)
Transfers	–	(2)
At 31 December	**120**	102

Represented by:

	2020 £m	2019 £m
Credit Valuation Adjustment	97	73
Debit Valuation Adjustment	(3)	(2)
Funding Valuation Adjustment	26	31
	120	102

Credit and Debit Valuation Adjustments (CVA and DVA) are applied to the Group's over-the-counter derivative exposures with counterparties that are not subject to strong interbank collateral arrangements. These exposures largely relate to the provision of risk management solutions for corporate customers.

A CVA is taken where the Group has a positive future uncollateralised exposure (asset). A DVA is taken where the Group has a negative future uncollateralised exposure (liability). These adjustments reflect interest rates and expectations of counterparty creditworthiness and the Group's own credit spread respectively.

The CVA is sensitive to:

– the current size of the mark-to-market position on the uncollateralised asset;
– expectations of future market volatility of the underlying asset; and
– expectations of counterparty creditworthiness.

In circumstances where exposures to a counterparty become impaired, any associated derivative valuation adjustment is transferred and assessed for specific loss alongside other non-derivative assets and liabilities that the counterparty may have with the Group.

39 Financial instruments (continued)

Market Credit Default Swap (CDS) spreads are used to develop the probability of default for quoted counterparties. For unquoted counterparties, internal credit ratings and market sector CDS curves and recovery rates are used. The Loss Given Default (LGD) is based on market recovery rates and internal credit assessments.

The combination of a one notch deterioration in the credit rating of derivative counterparties and a ten per cent increase in LGD increases the CVA by £29 million. Current market value is used to estimate the projected exposure for products not supported by the model, which are principally complex interest rate options that are traded in very low volumes. Where appropriate, the CVA for these products is calculated on an add-on basis (although no such adjustment was required at 31 December 2020).

The DVA is sensitive to:

- the current size of the mark-to-market position on the uncollateralised liability;
- expectations of future market volatility of the underlying liability; and
- the Group's own CDS spread.

A one per cent rise in the CDS spread would lead to an increase in the DVA of £7 million to £10 million.

The risk exposures that are used for the CVA and DVA calculations are strongly influenced by interest rates. Due to the nature of the Group's business the CVA/DVA exposures tend to be on average the same way around such that the valuation adjustments fall when interest rates rise. A one per cent rise in interest rates would lead to a £29 million fall in the overall valuation adjustment to £65 million. The CVA model used by the Group does not assume any correlation between the level of interest rates and default rates.

The Group has also recognised a Funding Valuation Adjustment to adjust for the net cost of funding uncollateralised derivative positions. This adjustment is calculated on the expected future exposure discounted at a suitable cost of funds. A ten basis points increase in the cost of funds will increase the funding valuation adjustment by approximately £5 million.

(ii) Market liquidity
The Group includes mid to bid-offer valuation adjustments against the expected cost of closing out the net market risk in the Group's trading positions within a timeframe that is consistent with historical trading activity and spreads that the trading desks have accessed historically during the ordinary course of business in normal market conditions.

At 31 December 2020, the Group's derivative trading business held mid to bid-offer valuation adjustments of £4 million (2019: £4 million).

39 Financial instruments (continued)

(D) Sensitivity of level 3 valuations
Level 3 portfolio

			At 31 December 2020			At 31 December 2019		
				Effect of reasonably possible alternative assumptions[2]			Effect of reasonably possible alternative assumptions[2]	
	Valuation techniques	Significant unobservable inputs[1]	Carrying value £m	Favourable changes £m	Unfavourable changes £m	Carrying value £m	Favourable changes £m	Unfavourable changes £m
Financial assets at fair value through profit or loss:								
Loans and advances to customers	Discounted cash flows	Interest rate spreads (bps) (-50bps/106bps)	**477**	**36**	**(34)**	463	22	(22)
Interest rate derivatives	Option pricing model	Interest rate reflecting (30%/60%)	**12**	**–**	**–**	–	–	–
Level 3 Financial assets carried at fair value			**489**			463		
Financial liabilities at fair value through profit or loss:								
Financial liabilities at fair value through profit or loss	Discounted cash flows	Interest rate spreads (+/- 50bps)	**45**	**1**	**(1)**	47	1	(1)
Shared appreciation rights	Market values – property valuation	HPI (+/- 1%)	**271**	**24**	**(22)**	297	17	(17)
Level 3 Financial liabilities carried at fair value			**316**			344		

1 Ranges are shown where appropriate and represent the highest and lowest inputs used in the level 3 valuations.

2 Where the exposure to an unobservable input is managed on a net basis, only the net impact is shown in the table.

3 Underlying asset/net asset values represent fair value.

Unobservable inputs

Significant unobservable inputs affecting the valuation of debt securities and derivatives are as follows:

- Interest rates and inflation rates are referenced in some derivatives where the payoff that the holder of the derivative receives depends on the behaviour of those underlying references through time.
- Credit spreads represent the premium above the benchmark reference instrument required to compensate for lower credit quality; higher spreads lead to a lower fair value.
- Volatility parameters represent key attributes of option behaviour; higher volatilities typically denote a wider range of possible outcomes.

Reasonably possible alternative assumptions

Valuation techniques applied to many of the Group's level 3 instruments often involve the use of two or more inputs whose relationship is interdependent. The calculation of the effect of reasonably possible alternative assumptions included in the table above reflects such relationships.

Debt securities

Reasonably possible alternative assumptions have been determined in respect of the Group's structured credit investment by flexing credit spreads.

39 Financial instruments (continued)

Derivatives
Reasonably possible alternative assumptions have been determined in respect of swaptions in the Group's derivative portfolios which are priced using industry standard option pricing models. Such models require interest rate volatilities which may be unobservable at longer maturities. To derive reasonably possible alternative valuations these volatilities were flexed within a range.

(4) Financial assets and liabilities carried at amortised cost

(A) Financial assets
Valuation hierarchy
The table below analyses the fair values of the financial assets of the Group and the Bank which are carried at amortised cost by valuation methodology (level 1, 2 or 3, as described on page 88). Loans and receivables are mainly classified as level 3 due to significant unobservable inputs used in the valuation models.

			Valuation hierarchy		
The Group	**Carrying value £m**	**Fair value £m**	**Level 1 £m**	**Level 2 £m**	**Level 3 £m**
At 31 December 2020					
Loans and advances to customers	**263,766**	**265,635**	**–**	**–**	**265,635**
Loans and advances to banks	**207**	**207**	**–**	**–**	**207**
Due from fellow Lloyds Banking Group undertakings	**28,988**	**28,988**	**–**	**–**	**28,988**
At 31 December 2019					
Loans and advances to customers	258,315	261,438	–	–	261,438
Loans and advances to banks	311	311	–	–	311
Due from fellow Lloyds Banking Group undertakings	97,534	97,534	–	–	97,534

39 Financial instruments (continued)

The Bank	Carrying value £m	Fair value £m	Valuation hierarchy Level 1 £m	Level 2 £m	Level 3 £m
At 31 December 2020					
Loans and advances to customers	**259,697**	**261,512**	**–**	**–**	**261,512**
Loans and advances to banks	**205**	**205**	**–**	**–**	**205**
Due from fellow Lloyds Banking Group undertakings	**38,726**	**38,726**	**–**	**–**	**38,726**
At 31 December 2019					
Loans and advances to customers	252,931	255,930	–	–	255,930
Loans and advances to banks	307	307	–	–	307
Due from fellow Lloyds Banking Group undertakings	108,935	108,935	–	–	108,935

Valuation methodology

Loans and advances to customers

The Group provides loans and advances to commercial, corporate and personal customers at both fixed and variable rates. Due to their short term nature, the carrying value of the variable rate loans and those relating to lease financing is assumed to be their fair value.

To determine the fair value of loans and advances to customers, loans are segregated into portfolios of similar characteristics. A number of techniques are used to estimate the fair value of fixed rate lending; these take account of expected credit losses based on historic trends, prevailing market interest rates and expected future cash flows. For retail exposures, fair value is usually estimated by discounting anticipated cash flows (including interest at contractual rates) at market rates for similar loans offered by the Group and other financial institutions. Certain loans secured on residential properties are made at a fixed rate for a limited period, typically two to five years, after which the loans revert to the relevant variable rate. The fair value of such loans is estimated by reference to the market rates for similar loans of maturity equal to the remaining fixed interest rate period. The fair value of commercial loans is estimated by discounting anticipated cash flows at a rate which reflects the effects of interest rate changes, adjusted for changes in credit risk.

Loans and advances to banks

The carrying value of short-dated loans and advances to banks is assumed to be their fair value. The fair value of loans and advances to banks is estimated by discounting the anticipated cash flows at a market discount rate adjusted for the credit spread of the obligor or, where not observable, the credit spread of borrowers of similar credit quality.

Reverse repurchase agreements

The carrying amount is deemed a reasonable approximation of fair value given the short-term nature of these instruments.

39 Financial instruments (continued)

(B) Financial liabilities

Valuation hierarchy

The table below analyses the fair values of the financial liabilities of the Group and the Bank which are carried at amortised cost by valuation methodology (level 1, 2 or 3, as described on page 88).

			Valuation hierarchy		
The Group	**Carrying value £m**	**Fair value £m**	**Level 1 £m**	**Level 2 £m**	**Level 3 £m**
At 31 December 2020					
Deposits from banks	**14,695**	**14,695**	**–**	**14,695**	**–**
Customer deposits	**163,001**	**163,148**	**–**	**163,148**	**–**
Due to fellow Lloyds Banking Group undertakings	**91,953**	**91,953**	**–**	**91,953**	**–**
Debt securities in issue	**8,297**	**8,622**	**–**	**8,622**	**–**
Subordinated liabilities	**6,964**	**6,990**	**–**	**6,990**	**–**
Repos included in above amounts:					
Deposits from banks	**13,680**	**13,680**	**–**	**13,680**	**–**
At 31 December 2019					
Deposits from banks	16,472	16,472	–	16,472	–
Customer deposits	151,845	152,038	–	152,012	26
Due to fellow Lloyds Banking Group undertakings	161,618	161,618	–	161,618	–
Debt securities in issue	11,204	11,146	–	11,146	–
Subordinated liabilities	6,101	6,133	–	6,133	–
Repos included in above amounts:					
Deposits from banks	15,460	15,460	–	15,460	–

			Valuation hierarchy		
The Bank	**Carrying value £m**	**Fair value £m**	**Level 1 £m**	**Level 2 £m**	**Level 3 £m**
At 31 December 2020					
Deposits from banks	**14,694**	**14,694**	**–**	**14,694**	**–**
Customer deposits	**163,000**	**163,147**	**–**	**163,147**	**–**
Due to fellow Lloyds Banking Group undertakings	**99,612**	**99,612**	**–**	**99,612**	**–**
Debt securities in issue	**7,012**	**7,226**	**–**	**7,226**	**–**
Subordinated liabilities	**6,964**	**6,990**	**–**	**6,990**	**–**
Repos included in above amounts:					
Deposits from banks	**13,680**	**13,680**	**–**	**13,680**	**–**
At 31 December 2019					
Deposits from banks	16,472	16,472	–	16,472	–
Customer deposits	151,818	152,011	–	152,011	–
Due to fellow Lloyds Banking Group undertakings	169,813	169,813	–	169,813	–
Debt securities in issue	9,700	9,683	–	9,683	–
Subordinated liabilities	6,101	6,133	–	6,133	–
Repos included in above amounts:					
Deposits from banks	15,460	15,460	–	15,460	–

Valuation methodology

Deposits from banks and customer deposits

The fair value of bank and customer deposits repayable on demand is assumed to be equal to their carrying value.

The fair value for all other deposits is estimated using discounted cash flows applying either market rates, where applicable, or current rates for deposits of similar remaining maturities.

Debt securities in issue

The fair value of short-term debt securities in issue is approximately equal to their carrying value. Fair value for other debt securities is calculated based on quoted market prices where available. Where quoted market prices are not available, fair value is estimated using discounted cash flow techniques at a rate which reflects market rates of interest and the Group's own credit spread.

39 Financial instruments (continued)

Subordinated liabilities
The fair value of subordinated liabilities is determined by reference to quoted market prices where available or by reference to quoted market prices of similar instruments. Subordinated liabilities are classified as level 2, since the inputs used to determine their fair value are largely observable.

Repurchase agreements
The carrying amount is deemed a reasonable approximation of fair value given the short term nature of these instruments.

(5) Reclassification of financial assets
There have been no reclassifications of financial assets in 2019 or 2020.

40 Transfers of financial assets

There were no significant transferred financial assets which were derecognised in their entirety, but with ongoing exposure. Details of transferred financial assets that continue to be recognised in full are as follows:

The Group and the Bank enters into repurchase and securities lending transactions in the normal course of business that do not result in derecognition of the financial assets as substantially all or the risks and rewards, including credit, interest rate, prepayment and other price risks are retained by the Group. In all cases, the transferee has the right to sell or repledge the assets concerned.

As set out in note 25, included within financial assets measured at amortised cost are loans transferred under the Group's securitisation and covered bond programmes. As the Group retains all or a majority of the risks and rewards associated with these loans, including credit, interest rate, prepayment and liquidity risk, they remain on the Group's balance sheet. Assets transferred into the Group's securitisation and covered bond programmes are not available to be used by the Group whilst the assets are within the programmes. However, the Group retains the right to remove loans from the covered bond programmes where they are in excess of the programme's requirements. In addition, where the Group has retained some of the notes issued by securitisation and covered bond programmes, the Group has the ability to sell or pledge these retained notes.

The table below sets out the carrying values of the transferred assets and the associated liabilities. For repurchase and securities lending transactions, the associated liabilities represent the Group's obligation to repurchase the transferred assets. For securitisation programmes, the associated liabilities represent the external notes in issue (note 25). Except as otherwise noted below, none of the liabilities shown in the table below have recourse only to the transferred assets.

	The Group		**The Bank**	
	Carrying value of transferred assets £m	**Carrying value of associated liabilities £m**	**Carrying value of transferred assets £m**	**Carrying value of associated liabilities £m**
At 31 December 2020				
Repurchase and securities lending transactions				
Financial assets at fair value through other comprehensive income	**37**	**–**	**37**	**–**
Securitisation programmes				
Loans and advances to customers[1,2]	**27,504**	**3,034**	**27,504**	**–**

	The Group		The Bank	
	Carrying value of transferred assets £m	Carrying value of associated liabilities £m	Carrying value of transferred assets £m	Carrying value of associated liabilities £m
At 31 December 2019				
Repurchase and securities lending transactions				
Financial assets at fair value through other comprehensive income	35	–	35	–
Securitisation programmes				
Loans and advances to customers[1,2]	30,417	5,616	30,417	–

1 The carrying value of associated liabilities for the Group excludes securitisation notes held by the Group of £23,199 million (2019: £23,632 million).

2 The carrying value of transferred assets for the Bank includes amounts relating to assets transferred to structured entities which are fully consolidated into the Group. The liabilities associated with such assets are issued by the structured entities.

41 Offsetting of financial assets and liabilities

The following information relates to financial assets and liabilities which have been offset in the balance sheet and those which have not been offset but for which the Group has enforceable master netting agreements or collateral arrangements in place with counterparties.

The Group At 31 December 2020	Gross amounts of assets and liabilities[1] £m	Amounts offset in the balance sheet £m	Net amounts presented in the balance sheet £m	Related amounts where set off in the balance sheet not permitted[2] Cash collateral received/ pledged £m	Related amounts where set off in the balance sheet not permitted[2] Non-cash collateral received/ pledged £m	Potential net amounts if offset of related amounts permitted £m
Financial assets						
Financial assets at fair value through profit or loss:						
Excluding reverse repos	477	–	477	–	–	477
Reverse repos	–	–	–	–	–	–
	477	–	477	–	–	477
Derivative financial instruments	7,423	–	7,423	(1,394)	(621)	5,408
Loans and advances to banks:						
Excluding reverse repos	207	–	207	(17)	–	190
Reverse repos	–	–	–	–	–	–
	207	–	207	(17)	–	190
Loans and advances to customers:						
Excluding reverse repos	263,766	–	263,766	(229)	(606)	262,931
Reverse repos	–	–	–	–	–	–
	263,766	–	263,766	(229)	(606)	262,931
Financial assets at fair value through other comprehensive income	2,395	–	2,395	–	–	2,395
Financial liabilities						
Deposits from banks:						
Excluding repos	1,015	–	1,015	(774)	–	241
Repos	13,680	–	13,680	–	(13,680)	–
	14,695	–	14,695	(774)	(13,680)	241
Customer deposits:						
Excluding repos	163,001	–	163,001	(620)	(606)	161,775
Repos	–	–	–	–	–	–
	163,001	–	163,001	(620)	(606)	161,775
Financial liabilities at fair value through profit or loss:						
Excluding repos	45	–	45	–	–	45
Repos	–	–	–	–	–	–
	45	–	45	–	–	45
Derivative financial instruments	8,672	–	8,672	(246)	(1,572)	6,854

1 After impairment allowance.

2 The Group enters into derivatives and repurchase and reverse repurchase agreements with various counterparties which are governed by industry standard master netting agreements. The Group holds and provides cash and securities collateral in respective of derivative transactions covered by these agreements. The right to set off balances under these master netting agreements or to set off cash and securities collateral only arises in the event of non-payment or default and, as a result, these arrangements do not qualify for offsetting under IAS 32.

The effects of over-collaterisation have not been taken into account in the above table.

41 Offsetting of financial assets and liabilities (continued)

The Group At 31 December 2019	Gross amounts of assets and liabilities[1] £m	Amounts offset in the balance sheet £m	Net amounts presented in the balance sheet £m	Related amounts where set off in the balance sheet not permitted[2] Cash collateral received/ pledged £m	Related amounts where set off in the balance sheet not permitted[2] Non-cash collateral received/ pledged £m	Potential net amounts if offset of related amounts permitted £m
Financial assets						
Financial assets at fair value through profit or loss:						
Excluding reverse repos	463	–	463	–	–	463
Reverse repos	–	–	–	–	–	–
	463	–	463	–	–	463
Derivative financial instruments	10,338	–	10,338	(936)	(883)	8,519
Loans and advances to banks:						
Excluding reverse repos	311	–	311	(239)	–	72
Reverse repos	–	–	–	–	–	–
	311	–	311	(239)	–	72
Loans and advances to customers:						
Excluding reverse repos	258,315	–	258,315	(206)	(668)	257,441
Reverse repos	–	–	–	–	–	–
	258,315	–	258,315	(206)	(668)	257,441
Financial assets at fair value through other comprehensive income	2,253	–	2,253	–	–	2,253
Financial liabilities						
Deposits from banks:						
Excluding repos	1,012	–	1,012	(792)	–	220
Repos	15,460	–	15,460	–	(15,460)	–
	16,472	–	16,472	(792)	(15,460)	220
Customer deposits:						
Excluding repos	151,845	–	151,845	(144)	(668)	151,033
Repos	–	–	–	–	–	–
	151,845	–	151,845	(144)	(668)	151,033
Financial liabilities at fair value through profit or loss:						
Excluding repos	47	–	47	–	–	47
Repos	–	–	–	–	–	–
	47	–	47	–	–	47
Derivative financial instruments	11,352	–	11,352	(445)	(865)	10,042

1 After impairment allowance.

2 The Group enters into derivatives and repurchase and reverse repurchase agreements with various counterparties which are governed by industry standard master netting agreements. The Group holds and provides cash and securities collateral in respective of derivative transactions covered by these agreements. The right to set off balances under these master netting agreements or to set off cash and securities collateral only arises in the event of non-payment or default and, as a result, these arrangements do not qualify for offsetting under IAS 32.

The effects of over-collaterisation have not been taken into account in the above table.

42 Financial risk management

Financial instruments are fundamental to the Group's activities and, as a consequence, the risks associated with financial instruments represent a significant component of the risks faced by the Group.

The primary risks affecting the Group through its use of financial instruments are: credit risk; market risk, which includes interest rate risk and foreign exchange risk; liquidity risk and capital risk. Information about the Group's exposure to each of the above risks and its capital can be found on pages 7 to 8. The following additional disclosures, which provide its quantitative information about the risks within financial instruments held or issued by the Group, should be read in conjunction with that earlier information.

(1) Credit risk

The Group's credit risk exposure arises in respect of the instruments below and predominantly in the United Kingdom. Credit risk appetite is set at Board level and is described and reported through a suite of metrics devised from a combination of accounting and credit portfolio performance measures, which include the use of various credit risk rating systems as inputs and measure the credit risk of loans and advances to customers and banks at a counterparty level using three components: (i) the probability of default by the counterparty on its contractual obligations; (ii) the current exposures to the counterparty and their likely future development, from which the Group derives the exposure at default; and (iii) the likely loss ratio on the defaulted obligations, the loss given default. The Group uses a range of approaches to mitigate credit risk, including internal control policies, obtaining collateral, using master netting agreements and other credit risk transfers, such as asset sales and credit derivatives based transactions.

A. Maximum credit exposure

The maximum credit risk exposure of the Group in the event of other parties failing to perform their obligations is detailed below. No account is taken of any collateral held and the maximum exposure to loss is considered to be the balance sheet carrying amount or, for non-derivative off-balance sheet transactions and financial guarantees, their contractual nominal amounts.

	At 31 December 2020			At 31 December 2019		
The Group	**Maximum exposure £m**	**Offset[2] £m**	**Net exposure £m**	Maximum exposure £m	Offset[2] £m	Net exposure £m
Loans and advances to banks, net[1]	**207**	**–**	**207**	311	–	311
Loans and advances to customers, net[1]	**263,766**	**(606)**	**263,160**	258,315	(668)	257,647
Financial assets at amortised cost	**263,973**	**(606)**	**263,367**	258,626	(668)	257,958
Financial assets at fair value through other comprehensive income[3]	**2,395**	**–**	**2,395**	2,253	–	2,253
Financial assets at fair value through profit or loss[3]:						
Loans and advances	**477**	**–**	**477**	463	–	463
Derivative assets	**7,423**	**(621)**	**6,802**	10,338	(865)	9,473
Off-balance sheet items:						
Acceptances and endorsements	**–**	**–**	**–**	1	–	1
Other items serving as direct credit substitutes	**18**	**–**	**18**	20	–	20
Performance bonds and other transaction-related contingencies	**189**	**–**	**189**	199	–	199
Irrevocable commitments and guarantees	**20,919**	**–**	**20,919**	14,478	–	14,478
	21,126	**–**	**21,126**	14,698	–	14,698
	295,394	**(1,227)**	**294,167**	286,378	(1,533)	284,845

1 Amounts shown net of related impairment allowances.

2 Offset items comprise deposit amounts available for offset and amounts available for offset under master netting arrangements that do not meet the criteria under IAS 32 to enable loans and advances and derivative assets respectively to be presented net of these balances in the financial statements.

3 Excluding equity shares.

42 Financial risk management (continued)

The Bank	At 31 December 2020 Maximum exposure £m	Offset[2] £m	Net exposure £m	At 31 December 2019 Maximum exposure £m	Offset[2] £m	Net exposure £m
Loans and advances to banks, net[1]	205	–	205	307	–	307
Loans and advances to customers, net[1]	259,697	(606)	259,091	252,931	(668)	252,263
Financial assets at amortised cost	259,902	(606)	259,296	253,238	(668)	252,570
Financial assets at fair value through other comprehensive income[3]	2,395	–	2,395	2,253	–	2,253
Financial assets at fair value through profit or loss[3]:						
Loans and advances	158	–	158	117	–	117
Derivative assets	7,423	(621)	6,802	10,296	(865)	9,431
Off-balance sheet items:						
Acceptances and endorsements	–	–	–	1	–	1
Other items serving as direct credit substitutes	18	–	18	20	–	20
Performance bonds and other transaction-related contingencies	189	–	189	199	–	199
Irrevocable commitments and guarantees	20,796	–	20,796	14,383	–	14,383
	21,003	–	21,003	14,603	–	14,603
	290,881	(1,227)	289,654	280,507	(1,533)	278,974

1 Amounts shown net of related impairment allowances.

2 Offset items comprise deposit amounts available for offset and amounts available for offset under master netting arrangements that do not meet the criteria under IAS 32 to enable loans and advances and derivative assets respectively to be presented net of these balances in the financial statements.

3 Excluding equity shares.

42 Financial risk management (continued)

B. Concentrations of exposure

The Group's management of concentration risk includes single name, industry sector and country limits as well as controls over the Group's overall exposure to certain products.

At 31 December 2020 the Group's most significant concentrations of exposure were in mortgages (comprising 93 per cent of total loans and advances to customers) and to other personal lending (comprising 3 per cent of the total).

Loans and advances to customers

	The Group		The Bank	
	2020 £m	2019 £m	**2020 £m**	2019 £m
Agriculture, forestry and fishing	**608**	609	**608**	609
Energy and water supply	**70**	88	**70**	88
Manufacturing	**273**	187	**273**	187
Construction	**973**	874	**973**	874
Transport, distribution and hotels	**3,019**	2,527	**3,019**	2,527
Postal and telecommunications	**159**	118	**159**	118
Property companies	**3,462**	3,744	**3,487**	3,769
Financial, business and other services	**1,627**	1,518	**1,627**	1,518
Personal:				
Mortgages[1]	**247,380**	239,923	**243,373**	234,624
Other	**8,973**	10,412	**8,964**	10,404
Lease financing	**235**	251	**–**	–
Hire purchase	**179**	149	**179**	149
Total loans and advances to customers before allowance for impairment losses	**266,958**	260,400	**262,732**	254,867
Allowance for impairment losses (note 15)	**(3,192)**	(2,085)	**(3,035)**	(1,936)
Total loans and advances to customers	**263,766**	258,315	**259,697**	252,931

1 Includes both UK and overseas mortgage balances.

The Group's operations are predominantly UK-based and as a result an analysis of credit risk exposures by geographical region is not provided.

C. Credit quality of assets

Loans and advances

The internal credit ratings systems used by the Group differ between retail and commercial, reflecting the characteristics of these exposures and the way that they are managed internally; these credit ratings are set out below. All probabilities of default (PDs) include forward-looking information and are based on 12 month values, with the exception of credit impaired.

Retail

Quality classification	IFRS 9 PD range
RMS 1-6	0.00-4.50%
RMS 7-9	4.51-14.00%
RMS 10	14.01-20.00%
RMS 11-13	20.01-99.99%
RMS 14	100%

Commercial

Quality classification	IFRS 9 PD range
CMS 1-10	0.00-0.50%
CMS 11-14	0.51-3.00%
CMS 15-18	3.01-20.00%
CMS 19	20.01-99.99%
CMS 20-23	100%

Stage 3 assets include balances of £65 million (2019: £79 million) (with outstanding amounts due of approximately £288 million (2019: £690 million)) which have been subject to a partial write-off and where the Group continues to enforce recovery action.

Stage 2 and Stage 3 assets of the Group with a carrying amount of £14,900 million (2019: £53 million) were modified during the year. No material gain or loss was recognised by the Group.

As at 31 December 2020 and 2019, assets that had been previously modified whilst classified as Stage 2 or Stage 3 and were classified as Stage 1 were not material.

42 Financial risk management (continued)

The Group - Gross drawn exposures and expected credit loss allowances	Drawn exposures Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m	Expected credit loss allowance Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m
At 31 December 2020								
Loans and advances to banks:								
CMS 1-10	207	–	–	207	–	–	–	–
CMS 11-14	–	–	–	–	–	–	–	–
CMS 15-18	–	–	–	–	–	–	–	–
CMS 19	–	–	–	–	–	–	–	–
CMS 20-23	–	–	–	–	–	–	–	–
	207	–	–	207	–	–	–	–
Loans and advances to customers:								
RMS 1-6	218,352	22,023	–	240,375	(169)	(358)	–	(527)
RMS 7-9	1,629	5,043	–	6,672	(68)	(202)	–	(270)
RMS 10	62	1,532	–	1,594	(7)	(84)	–	(91)
RMS 11-13	186	4,512	–	4,698	(5)	(402)	–	(407)
RMS 14	–	–	4,207	4,207	–	–	(788)	(788)
	220,229	33,110	4,207	257,546	(249)	(1,046)	(788)	(2,083)
CMS 1-10	2,667	1	–	2,668	(1)	–	–	(1)
CMS 11-14	3,171	458	–	3,629	(19)	(12)	–	(31)
CMS 15-18	677	776	–	1,453	(17)	(63)	–	(80)
CMS 19	2	92	–	94	–	(25)	–	(25)
CMS 20-23	–	–	1,568	1,568	–	–	(772)	(772)
	6,517	1,327	1,568	9,412	(37)	(100)	(772)	(909)
Central overlay	—	—	—	—	(200)	—	—	(200)
Total loans and advances to customers	226,746	34,437	5,775	266,958	(486)	(1,146)	(1,560)	(3,192)

The Group - Gross undrawn exposures and expected credit loss allowances								
Loans and advances to customers:								
RMS 1-6	40,170	1,853	–	42,023	(39)	(29)	–	(68)
RMS 7-9	323	230	–	553	(8)	(11)	–	(19)
RMS 10	7	32	–	39	–	(3)	–	(3)
RMS 11-13	1	59	–	60	–	(12)	–	(12)
RMS 14	–	–	41	41	–	–	–	–
	40,501	2,174	41	42,716	(47)	(55)	–	(102)
CMS 1-10	3,389	—	–	3,389	(1)	–	–	(1)
CMS 11-14	796	359	–	1,155	(4)	(4)	–	(8)
CMS 15-18	97	179	–	276	(2)	(6)	–	(8)
CMS 19	–	30	–	30	–	(4)	–	(4)
CMS 20-23	–	–	6	6	–	–	(6)	(6)
	4,282	568	6	4,856	(7)	(14)	(6)	(27)
Total loans and advances to customers	44,783	2,742	47	47,572	(54)	(69)	(6)	(129)

42 Financial risk management (continued)

	Drawn exposures				Expected credit loss allowance			
The Group - Gross drawn exposures and expected credit loss allowances	**Stage 1 £m**	**Stage 2 £m**	**Stage 3 £m**	**Total £m**	**Stage 1 £m**	**Stage 2 £m**	**Stage 3 £m**	**Total £m**
At 31 December 2019								
Loans and advances to banks:								
CMS 1-10	311	–	–	311	–	–	–	–
CMS 11-14	–	–	–	–	–	–	–	–
CMS 15-18	–	–	–	–	–	–	–	–
CMS 19	–	–	–	–	–	–	–	–
CMS 20-23	–	–	–	–	–	–	–	–
	311	–	–	311	–	–	–	–
Loans and advances to customers:								
RMS 1-6	220,665	17,928	–	238,593	(93)	(344)	–	(437)
RMS 7-9	950	3,570	–	4,520	(37)	(133)	–	(170)
RMS 10	30	763	–	793	(3)	(46)	–	(49)
RMS 11-13	142	1,907	–	2,049	(2)	(190)	–	(192)
RMS 14	–	–	5,040	5,040	–	–	(641)	(641)
	221,787	24,168	5,040	250,995	(135)	(713)	(641)	(1,489)
CMS 1-10	5,548	66	–	5,614	(5)	(2)	–	(7)
CMS 11-14	2,215	269		2,484	(7)	(6)	–	(13)
CMS 15-18	184	473	–	657	(2)	(28)	–	(30)
CMS 19	7	20	–	27	–	–	–	—
CMS 20-23	–	–	623	623	–	–	(546)	(546)
	7,954	828	623	9,405	(14)	(36)	(546)	(596)
Total loans and advances to customers	229,741	24,996	5,663	260,400	(149)	(749)	(1,187)	(2,085)

The Group - Gross undrawn exposures and expected credit loss allowances								
Loans and advances to customers:								
RMS 1-6	33,047	1,470	–	34,517	(21)	(14)	–	(35)
RMS 7-9	79	35	–	114	(2)	(3)	–	(5)
RMS 10	1	8	–	9	–	(1)	–	(1)
RMS 11-13	–	11	–	11	–	(4)	–	(4)
RMS 14	–	–	39	39	–	–	–	–
	33,127	1,524	39	34,690	(23)	(22)		(45)
CMS 1-10	2,082	8	–	2,090	(2)	–	–	(2)
CMS 11-14	821	107	–	928	(1)	(1)	–	(2)
CMS 15-18	28	173	–	201	–	(5)	–	(5)
CMS 19	–	2	–	2	–	–	–	–
CMS 20-23	–	–	1	1	–	–	(1)	(1)
	2,931	290	1	3,222	(3)	(6)	(1)	(10)
Total loans and advances to customers	36,058	1,814	40	37,912	(26)	(28)	(1)	(55)

42 Financial risk management (continued)

The Bank - Gross drawn exposures and expected credit loss allowances	Drawn exposures Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m	Expected credit loss allowance Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m
At 31 December 2020								
Loans and advances to banks:								
CMS 1-10	205	–	–	205	–	–	–	–
CMS 11-14	–	–	–	–	–	–	–	–
CMS 15-18	–	–	–	–	–	–	–	–
CMS 19	–	–	–	–	–	–	–	–
CMS 20-23	–	–	–	–	–	–	–	–
	205	–	–	205	–	–	–	–
Loans and advances to customers:								
RMS 1-6	216,210	21,398	–	237,608	(166)	(335)	–	(501)
RMS 7-9	1,614	4,704	–	6,318	(67)	(186)	–	(253)
RMS 10	62	1,426	–	1,488	(7)	(77)	–	(84)
RMS 11-13	65	4,223	–	4,288	(5)	(368)	–	(373)
RMS 14	–	–	3,827	3,827	–	–	(685)	(685)
	217,951	31,751	3,827	253,529	(245)	(966)	(685)	(1,896)
CMS 1-10	2,667	1	–	2,668	(1)	–	–	(1)
CMS 11-14	3,067	458	–	3,525	(19)	(12)	–	(31)
CMS 15-18	650	672	–	1,322	(17)	(63)	–	(80)
CMS 19	2	92	–	94	–	(25)	–	(25)
CMS 20-23	–	–	1,594	1,594	–	–	(802)	(802)
	6,386	1,223	1,594	9,203	(37)	(100)	(802)	(939)
Central overlay	—	—	—	—	(200)	—	—	(200)
Total loans and advances to customers	224,337	32,974	5,421	262,732	(482)	(1,066)	(1,487)	(3,035)

The Bank - Gross undrawn exposures and expected credit loss allowances								
Loans and advances to customers:								
RMS 1-6	40,072	1,795	–	41,867	(39)	(29)	–	(68)
RMS 7-9	322	225	–	547	(8)	(11)	–	(19)
RMS 10	7	32	–	39	–	(3)	–	(3)
RMS 11-13	1	58	–	59	–	(12)	–	(12)
RMS 14	–	–	40	40	–	–	–	–
	40,402	2,110	40	42,552	(47)	(55)	–	(102)
CMS 1-10	3,389	–	–	3,389	(1)	–	–	(1)
CMS 11-14	796	359	–	1,155	(4)	(4)	–	(8)
CMS 15-18	97	179	–	276	(2)	(6)	–	(8)
CMS 19	–	30	–	30	–	(4)	–	(4)
CMS 20-23	–	–	6	6	–	–	(6)	(6)
	4,282	568	6	4,856	(7)	(14)	(6)	(27)
Total loans and advances to customers	44,684	2,678	46	47,408	(54)	(69)	(6)	(129)

42 Financial risk management (continued)

	Drawn exposures				Expected credit loss allowance			
The Bank - Gross drawn exposures and expected credit loss allowances	**Stage 1 £m**	**Stage 2 £m**	**Stage 3 £m**	**Total £m**	**Stage 1 £m**	**Stage 2 £m**	**Stage 3 £m**	**Total £m**
At 31 December 2019								
Loans and advances to banks:								
CMS 1-10	307	–	–	307	–	–	–	–
CMS 11-14	–	–	–	–	–	–	–	–
CMS 15-18	–	–	–	–	–	–	–	–
CMS 19	–	–	–	–	–	–	–	–
CMS 20-23	–	–	–	–	–	–	–	–
	307	–	–	307	–	–	–	–
Loans and advances to customers:								
RMS 1-6	217,018	17,135	–	234,153	(91)	(308)	–	(399)
RMS 7-9	944	3,374	–	4,318	(37)	(119)	–	(156)
RMS 10	30	711	–	741	(3)	(42)	–	(45)
RMS 11-13	9	1,810	–	1,819	(2)	(177)	–	(179)
RMS 14	–	–	4,659	4,659	–	–	(551)	(551)
	218,001	23,030	4,659	245,690	(133)	(646)	(551)	(1,330)
CMS 1-10	5,296	65	–	5,361	(5)	(2)	–	(7)
CMS 11-14	2,215	269		2,484	(7)	(6)	–	(13)
CMS 15-18	184	473	–	657	(2)	(28)	–	(30)
CMS 19	7	20	–	27	–	–	–	—
CMS 20-23	–	–	648	648	–	–	(556)	(556)
	7,702	827	648	9,177	(14)	(36)	(556)	(606)
Total loans and advances to customers	225,703	23,857	5,307	254,867	(147)	(682)	(1,107)	(1,936)

The Bank - Gross undrawn exposures and expected credit loss allowances								
Loans and advances to customers:								
RMS 1-6	32,931	1,417	–	34,348	(21)	(14)	–	(35)
RMS 7-9	79	35	–	114	(2)	(3)	–	(5)
RMS 10	1	8	–	9	–	(1)	–	(1)
RMS 11-13	–	11	–	11	–	(4)	–	(4)
RMS 14	–	–	39	39	–	–	–	–
	33,011	1,471	39	34,521	(23)	(22)		(45)
CMS 1-10	2,082	8	–	2,090	(2)	–	–	(2)
CMS 11-14	821	107	–	928	(1)	(1)	–	(2)
CMS 15-18	28	173	–	201	–	(5)	–	(5)
CMS 19	–	2	–	2	–	–	–	–
CMS 20-23	–	–	1	1	–	–	(1)	(1)
	2,931	290	1	3,222	(3)	(6)	(1)	(10)
Total loans and advances to customers	35,942	1,761	40	37,743	(26)	(28)	(1)	(55)

42 Financial risk management (continued)

Debt securities held at amortised cost
An analysis by credit rating of debt securities held at amortised at cost is provided below:

	2020			2019		
The Group and the Bank	**Investment grade[1] £m**	**Other[2] £m**	**Total £m**	Investment grade[1] £m	Other[2] £m	Total £m
Corporate and other debt securities:						
Gross exposure	**–**	**1**	**1**	–	1	1
Allowance for impairment losses			**(1)**			(1)
Total debt securities held at amortised cost			**–**			–

1 Credit ratings equal to or better than 'BBB'.

2 Other comprises sub-investment grade (2020: £nil; 2019: £nil) and not rated (2020: £1 million; 2019: £1 million).

Financial assets at fair value through other comprehensive income
An analysis of financial assets at fair value through other comprehensive income is included in note 17. The credit quality of financial assets at fair value through other comprehensive income is set out below:

	2020			2019		
The Group and the Bank	**Investment grade[1] £m**	**Other[2] £m**	**Total £m**	Investment grade[1] £m	Other[2] £m	Total £m
Corporate and other debt securities	**2,342**	**53**	**2,395**	2,253	–	2,253

1 Credit ratings equal to or better than 'BBB'.

2 Other comprises sub-investment grade (2020: £nil; 2019: £nil) and not rated (2020: £53 million; 2019: £nil).

42 Financial risk management (continued)

Derivative assets
An analysis of derivative assets is given in note 14. The Group reduces exposure to credit risk by using master netting agreements and by obtaining collateral in the form of cash or highly liquid securities. In respect of the net credit risk relating to derivative assets of £6,802 million for the Group and £6,802 million for the Bank (2019: £9,473 million for the Group and £9,431 million for the Bank), cash collateral of £1,394 million for the Group and the Bank (2019: £936 million for the Group and for the Bank) was held and a further £35 million for the Group and the Bank was due from OECD banks (2019: £54 million for the Group and the Bank).

	2020			2019		
	Investment grade[1] £m	Other[2] £m	Total £m	Investment grade[1] £m	Other[2] £m	Total £m
The Group						
Trading and other	**1,665**	**861**	**2,526**	1,838	1,056	2,894
Hedging	**78**	**–**	**78**	418	–	418
	1,743	**861**	**2,604**	2,256	1,056	3,312
Due from fellow Group undertakings			**4,819**			7,026
Total derivative financial instruments			**7,423**			10,338
The Bank						
Trading and other	**1,665**	**853**	**2,518**	1,796	1,056	2,852
Hedging	**78**	**–**	**78**	418	–	418
	1,743	**853**	**2,596**	2,214	1,056	3,270
Due from fellow Group undertakings			**4,827**			7,026
Total derivative financial instruments			**7,423**			10,296

1 Credit ratings equal to or better than 'BBB'.

2 Other comprises sub-investment grade (2020 the Group and the Bank: £834 million; 2019 the Group and the Bank: £760 million) and not rated (2020 the Group: £27 million; and the Bank: £19 million; 2019 the Group and the Bank: £296 million).

Financial guarantees and irrevocable loan commitments
Financial guarantees represent undertakings that the Group will meet a customer's obligation to third parties if the customer fails to do so. Commitments to extend credit represent unused portions of authorisations to extend credit in the form of loans, guarantees or letters of credit. The Group is theoretically exposed to loss in an amount equal to the total guarantees or unused commitments, however, the likely amount of loss is expected to be significantly less; most commitments to extend credit are contingent upon customers maintaining specific credit standards.

D. Collateral held as security for financial assets
The Group holds collateral against loans and advances and irrevocable loan commitments; qualitative and, where appropriate, quantitative information is provided in respect of this collateral below. Collateral held as security for financial assets at fair value through profit or loss and for derivative assets is also shown below.

The Group holds collateral in respect of loans and advances to banks and customers as set out below. The Group does not hold collateral against debt securities, comprising asset-backed securities and corporate and other debt securities, which are classified as financial assets held at amortised cost.

Loans and advances to banks
These transactions were generally conducted under terms that are usual and customary for standard secured lending activities.

Loans and advances to customers
Retail lending
Mortgages
An analysis by loan-to-value ratio of the Group's and the Bank's UK residential mortgage lending is provided below. The value of collateral used in determining the loan-to-value ratios has been estimated based upon the last actual valuation, adjusted to take into account subsequent movements in house prices, after making allowances for indexation error and dilapidations.

In some circumstances, where the discounted value of the estimated net proceeds from the liquidation of collateral (i.e. net of costs, expected haircuts and anticipated changes in the value of the collateral to the point of sale) is greater than the estimated exposure at default, no credit losses are expected and no ECL allowance is recognised.

42 Financial risk management (continued)

The Group	Stage 1 £m	Stage 2 £m	Stage 3 £m	Total gross £m
At 31 December 2020				
Less than 70 per cent	**150,490**	**26,028**	**2,872**	**179,390**
70 per cent to 80 per cent	**40,234**	**3,555**	**439**	**44,228**
80 per cent to 90 per cent	**20,273**	**1,051**	**218**	**21,542**
90 per cent to 100 per cent	**468**	**178**	**103**	**749**
Greater than 100 per cent	**156**	**393**	**256**	**805**
Total	**211,621**	**31,205**	**3,888**	**246,714**

The Group	Stage 1 £m	Stage 2 £m	Stage 3 £m	Total gross £m
At 31 December 2019				
Less than 70 per cent	142,536	17,780	2,414	162,730
70 per cent to 80 per cent	39,580	3,118	516	43,214
80 per cent to 90 per cent	24,395	1,330	308	26,033
90 per cent to 100 per cent	5,043	286	143	5,472
Greater than 100 per cent	306	434	304	1,044
Total	211,860	22,948	3,685	238,493

The Bank	Stage 1 £m	Stage 2 £m	Stage 3 £m	Total gross £m
At 31 December 2020				
Less than 70 per cent	**148,650**	**24,996**	**2,653**	**176,299**
70 per cent to 80 per cent	**40,002**	**3,382**	**393**	**43,777**
80 per cent to 90 per cent	**20,229**	**996**	**185**	**21,410**
90 per cent to 100 per cent	**450**	**156**	**84**	**690**
Greater than 100 per cent	**132**	**321**	**198**	**651**
Total	**209,463**	**29,851**	**3,513**	**242,827**

The Bank	Stage 1 £m	Stage 2 £m	Stage 3 £m	Total gross £m
At 31 December 2019				
Less than 70 per cent	140,386	17,034	2,233	159,653
70 per cent to 80 per cent	39,080	2,919	451	42,450
80 per cent to 90 per cent	24,277	1,252	266	25,795
90 per cent to 100 per cent	5,011	263	116	5,390
Greater than 100 per cent	244	367	238	849
Total	208,998	21,835	3,304	234,137

Commercial lending

Stage 3 secured lending

The value of collateral is re-evaluated and its legal soundness re-assessed if there is observable evidence of distress of the borrower; this evaluation is used to determine potential loss allowances and management's strategy to try to either repair the business or recover the debt.

At 31 December 2020, Stage 3 secured commercial lending amounted to £495 million, net of an impairment allowance of £86 million (2019: £546 million, net of an impairment allowance of £48 million). The fair value of the collateral held in respect of Stage 3 secured commercial lending was £162 million (2019: £275 million). In determining the fair value of collateral, no specific amounts have been attributed to the costs of realisation. For the purposes of determining the total collateral held by the Group in respect of Stage 3 secured commercial lending, the value of collateral for each loan has been limited to the principal amount of the outstanding advance in order to eliminate the effects of any over-collateralisation and to provide a clearer representation of the Group's exposure.

Stage 3 secured commercial lending and associated collateral relates to lending to property companies and to customers in the financial, business and other services; transport, distribution and hotels; and construction industries.

Stage 1 and Stage 2 secured lending

For Stage 1 and Stage 2 secured commercial lending, the Group reports assets gross of collateral and therefore discloses the maximum loss exposure. The Group believes that this approach is appropriate as collateral values at origination and during a period of good performance may not be representative of the value of collateral if the obligor enters a distressed state.

42 Financial risk management (continued)

Stage 1 and Stage 2 secured commercial lending is predominantly managed on a cash flow basis. On occasion, it may include an assessment of underlying collateral, although, for Stage 3 lending, this will not always involve assessing it on a fair value basis. No aggregated collateral information for the entire unimpaired secured commercial lending portfolio is provided to key management personnel.

Financial assets at fair value through profit or loss
There were no repurchase agreements included in financial assets at fair value through profit or loss for either the Group or the Bank at 31 December in either 2020 or 2019.

In addition, securities held as collateral in the form of stock borrowed amounted to £12,283 million for the Group and the Bank (2019: £20,366 million for the Group and the Bank). At 31 December 2020, £12,283 million for the Group and the Bank had been resold or repledged as collateral for the Group's own transactions (2019: £20,366 million for the Group and the Bank).

These transactions were generally conducted under terms that are usual and customary for standard secured lending activities.

Derivative assets, after offsetting of amounts under master netting arrangements
The Group reduces exposure to credit risk by using master netting agreements and by obtaining collateral in the form of cash or highly liquid securities. In respect of the net derivative assets after offsetting of amounts under master netting arrangements of £6,802 million for the Group and £6,802 million for the Bank (2019: £9,473 million for the Group and £9,431 million for the Bank), cash collateral of £1,394 million for the Group and the Bank (2019: £936 million for the Group and the Bank) was held.

Irrevocable loan commitments and other credit-related contingencies
At 31 December 2020, there were irrevocable loan commitments and other credit-related contingencies of £21,126 million for the Group and £21,003 million for the Bank (2019: £14,698 million for the Group and £14,603 million for the Bank). Collateral is held as security, in the event that lending is drawn down, on £17,828 million for the Group and on £17,705 million for the Bank (2019: £11,271 million for the Group and £11,143 million for the Bank) of these balances.

Collateral repossessed
During the year, £120 million for the Group and £100 million for the Bank of collateral was repossessed (2019: £387 million for the Group and £351 million for the Bank), consisting primarily of residential property. In respect of retail portfolios, the Group does not take physical possession of properties or other assets held as collateral and uses external agents to realise the value as soon as practicable, generally at auction, to settle indebtedness. Any surplus funds are returned to the borrower or are otherwise dealt with in accordance with appropriate insolvency regulations. In certain circumstances the Group takes physical possession of assets held as collateral against commercial lending. In such cases, the assets are carried on the Group's balance sheet and are classified according to the Group's accounting policies.

E. Collateral pledged as security

The Group pledges assets primarily for repurchase agreements and securities lending transactions which are generally conducted under terms that are usual and customary for standard securitised borrowing contracts.

Repurchase transactions
Deposits from banks
Included in deposits from banks are deposits held as collateral for facilities granted, with a carrying value of £13,680 million for the Group and the Bank (2019: £15,460 million for the Group and Bank); the fair value of the collateral provided under these agreements at 31 December 2020 was £13,677 million for the Group and the Bank (2019: £15,427 million for the Group and Bank).

Financial liabilities at fair value through profit or loss
There were no repurchase transactions included in financial liabilities at fair value through profit or loss for either the Group or the Bank at 31 December in either 2020 or 2019.

Securities lending transactions
The following on balance sheet financial assets have been lent to counterparties under securities lending transactions:

	The Group		The Bank	
	2020 £m	2019 £m	**2020 £m**	2019 £m
Financial assets at fair value through other comprehensive income	**37**	35	**37**	35

Securitisations and covered bonds
In addition to the assets detailed above, the Group also holds assets that are encumbered through the Group's securitisation and covered bond programmes. Further details of these are provided in note 25.

(2) Market risk
Interest rate risk
Interest rate risk arises from the different repricing characteristics of the assets and liabilities. Liabilities are either insensitive to interest rate movements, for example interest free or very low interest customer deposits, or are sensitive to interest rate changes but bear rates which may be varied at the Group's discretion and that for competitive reasons generally reflect changes in the Bank of England's base rate. The rates on the remaining deposits are contractually fixed for their term to maturity.

Many banking assets are sensitive to interest rate movements; there is a large volume of managed rate assets such as variable rate mortgages which may be considered as a natural offset to the interest rate risk arising from the managed rate liabilities. However, a significant proportion of the Group's lending assets, for example many personal loans and mortgages, bear interest rates which are contractually fixed.

The Group's risk management policy is to optimise reward whilst managing its market risk exposures within the risk appetite defined by the Board. The largest residual risk exposure arises from balances that are deemed to be insensitive to changes in market rates (including current accounts, a portion of variable rate

42 Financial risk management (continued)

deposits and investable equity), and is managed through the Group's structural hedge. The structural hedge consists of longer-term fixed rate assets or interest rate swaps and the amount and duration of the hedging activity is reviewed regularly by the Lloyds Banking Group Asset and Liability Committee.

The Group and the Bank establishes hedge accounting relationships for interest rate risk using cash flow hedges and fair value hedges. The Group and the Bank are exposed to cash flow interest rate risk on its variable rate loans and deposits together with its floating rate subordinated debt. The derivatives used to manage the structural hedge may be designated into cash flow hedges to manage income statement volatility. The economic items related to the structural hedge, for example current accounts, are not eligible hedged items under IAS 39 for inclusion into accounting hedge relationships. The Group and the Bank are exposed to fair value interest rate risk on its fixed rate customer loans, its fixed rate customer deposits and the majority of its subordinated debt. The Group and the Bank apply netting between similar risks before applying hedge accounting.

Hedge ineffectiveness arises during the management of interest rate risk due to residual unhedged risk. Sources of ineffectiveness, which the Group may decide to not fully mitigate, can include basis differences, timing differences and notional amount differences. The effectiveness of accounting hedge relationships is assessed between the hedging derivatives and the documented hedged item, which can differ to the underlying economically hedged item.

At 31 December 2020 the aggregate notional principal of interest rate swaps designated as fair value hedges was £4,235 million (2019: £6,051 million) for the Group and the Bank with a net fair value asset of £427 million (2019: £710 million) for the Group and the Bank (see note 14). The losses on the hedging instruments were £23 million (2019: losses of £94 million) for the Group and the Bank. The gains on the hedged items attributable to the hedged risk were £23 million (2019: gains of £97 million) for the Group and the Bank. The gains and losses relating to the fair value hedges are recorded in net trading income.

In addition the Group has a small number of cash flow hedges which are primarily used to hedge the variability in the cost of funding within the commercial business. The notional principal of the interest rate swaps designated as cash flow hedges at 31 December 2020 was £9,993 million (2019: £13,227 million) for the Group and the Bank with a net fair value liability of £140 million (2019: liability of £183 million) for the Group and the Bank (see note 14). In 2020, ineffectiveness recognised in the income statement that arises from cash flow liability was £nil (2019: £nil) for the Group and the Bank.

Interest Rate Benchmark Reform

For the purposes of:

- determining whether a forecast transaction is highly probable;
- determining whether the hedged future cash flows are expected to occur;
- determining whether a hedge is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk; and
- determining whether an accounting hedging relationship should be discontinued because of a failure of the retrospective effectiveness test

the Group has assumed that the interest rate benchmark on which the hedged risk or the cash flows of the hedged item or hedging instrument are based is not altered by uncertainties resulting from the proposed interest rate benchmark reform. In addition, for a fair value hedge of a non-contractually specified benchmark portion of interest rate risk, the Group assesses only at inception of the hedge relationship and not on an ongoing basis that the risk is separately identifiable and hedge effectiveness can be measured. The Group's most significant hedge accounting relationships are exposed to the following interest rate benchmarks: Sterling LIBOR, US Dollar LIBOR and EURIBOR.

At 31 December 2020, the Group expects that EURIBOR will continue to exist as a benchmark rate for the foreseeable future and, as a result does not anticipate changing the hedged risk to a different benchmark. Accordingly, the Group does not consider its fair value or cash flow hedges of the EURIBOR benchmark interest rate to be directly affected by interest rate benchmark reform.

The notional of the hedged items that the Group and the Bank has designated into cash-flow hedge relationships that is directly affected by the interest rate benchmark reform is £3,498 million (2019: £4,038 million), of which £3,471 million (2019: £3,858 million) relates to Sterling LIBOR. These are principally loans and advances to commercial customers.

The interest rate benchmark reforms also affect, for the Group and the Bank, assets designated in fair value hedges with a notional of £610 million (2019: £602 million), of which £603 million (2019: £602 million) is in respect of sterling LIBOR, and liabilities designated in fair value hedges with a notional of £1,044 million (2019: £5,685 million), of which £702 million (2019: £818 million) is in respect of sterling LIBOR. These fair value hedges principally relate to debt securities in issue.

At 31 December 2020, the notional amount of the Group's and the Bank's hedging instruments in hedging relationships to which these amendments apply was £11,470 million (2019: £19,279 million), of which £1,124 million (2019: £1,497 million) relates to Sterling LIBOR fair value hedges and £9,895 million (2019: £12,823 million) relates to Sterling LIBOR cash flow hedges.

The Group is managing the process to transition to alternative benchmark rates under its Group-wide IBOR Transition Programme. This programme has developed an implementation plan for new products and a transition plan for legacy products. The programme also encompasses the associated impacts on systems, processes, accounting and reporting and includes dealing with the impact on hedge accounting relationships of the transition to alternative reference rates.

Foreign exchange risk

The corporate and retail businesses incur foreign exchange risk in the course of providing services to their customers. All non-structural foreign exchange exposures in the non-trading book are transferred to the trading area where they are monitored and controlled. These risks reside in the authorised trading centres who are allocated exposure limits. The limits are monitored daily by the local centres and reported to the central market and liquidity risk function in London.

The Group also manages foreign exchange risk via cash flow hedge accounting, utilising currency swaps.

Risk arises from the Group's investments in its overseas operations. The Group's structural foreign currency exposure is represented by the net asset value of the foreign currency equity and subordinated debt investments in its subsidiaries and branches. Gains or losses on structural foreign currency exposures are taken to reserves.

The Group ceased all hedging of the currency translation risk of the net investment in foreign operations on 1 January 2018.

The Group's main overseas operations are in Europe. Structural foreign currency exposures in respect of operations with a Euro functional currency are £71 million (2019: £162 million) for the Group and £73 million (2019: £193 million) for the Bank.

42 Financial risk management (continued)

(3) Liquidity risk

Liquidity risk is defined as the risk that the Group has insufficient financial resources to meet its commitments as they fall due, or can only secure them at excessive cost. Liquidity risk is managed through a series of measures, tests and reports that are primarily based on contractual maturity. The Group carries out monthly stress testing of its liquidity position against a range of scenarios, including those prescribed by the PRA. The Group's liquidity risk appetite is also calibrated against a number of stressed liquidity metrics.

The table below analyses financial instrument liabilities of the Group, on an undiscounted future cash flow basis according to contractual maturity, into relevant maturity groupings based on the remaining period at the balance sheet date; balances with no fixed maturity are included in the over 5 years category. Certain balances, included in the table below on the basis of their residual maturity, are repayable on demand upon payment of a penalty.

The Group	Up to 1 month £m	1-3 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	Total £m
At 31 December 2020						
Liabilities						
Deposits from banks	**16**	**2**	**57**	**18,329**	**137**	**18,541**
Customer deposits	**151,762**	**2,680**	**4,030**	**4,705**	**12**	**163,189**
Financial liabilities at fair value through profit or loss	**–**	**–**	**–**	**–**	**45**	**45**
Debt securities in issue	**175**	**82**	**2,761**	**4,803**	**1,026**	**8,847**
Other liabilities	**9**	**17**	**76**	**295**	**303**	**700**
Subordinated liabilities	**–**	**15**	**383**	**179**	**2,489**	**3,066**
Total non-derivative financial liabilities	**151,962**	**2,796**	**7,307**	**28,311**	**4,012**	**194,388**
Derivative financial liabilities:						
Gross settled derivatives – outflows	**478**	**81**	**955**	**614**	**2,059**	**4,187**
Gross settled derivatives – inflows	**(391)**	**(21)**	**(936)**	**(619)**	**(2,256)**	**(4,223)**
Gross settled derivatives – net flows	**87**	**60**	**19**	**(5)**	**(197)**	**(36)**
Net settled derivative liabilities	**702**	**4**	**10**	**70**	**120**	**906**
Total derivative financial liabilities	**789**	**64**	**29**	**65**	**(77)**	**870**
At 31 December 2019						
Liabilities						
Deposits from banks	166	–	105	16,318	–	16,589
Customer deposits	135,377	1,820	7,134	7,924	13	152,268
Financial liabilities at fair value through profit or loss	–	–	–	–	47	47
Debt securities in issue	599	2,098	2,120	6,120	827	11,764
Other liabilities	1	25	77	344	421	868
Subordinated liabilities	67	69	107	1,504	9,853	11,600
Total non-derivative financial liabilities	136,210	4,012	9,543	32,210	11,161	193,136
Derivative financial liabilities:						
Gross settled derivatives – outflows	862	147	588	1,772	1,754	5,123
Gross settled derivatives – inflows	(36)	(113)	(585)	(1,800)	(1,918)	(4,452)
Gross settled derivatives – net flows	826	34	3	(28)	(164)	671
Net settled derivative liabilities	4,030	5	15	47	140	4,237
Total derivative financial liabilities	4,856	39	18	19	(24)	4,908

The principal amount for undated subordinated liabilities with no redemption option is included within the over 5 years column; interest of approximately £6 million (2019: £8 million) for the Group and the Bank per annum which is payable in respect of those instruments for as long as they remain in issue is not included beyond five years.

42 Financial risk management (continued)

The Bank	Up to 1 month £m	1-3 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	Total £m
At 31 December 2020						
Liabilities						
Deposits from banks	**16**	**2**	**57**	**18,329**	**136**	**18,540**
Customer deposits	**151,762**	**2,680**	**4,030**	**4,705**	**12**	**163,189**
Debt securities in issue	**–**	**77**	**1,975**	**3,412**	**585**	**6,049**
Other liabilities	**9**	**17**	**76**	**295**	**303**	**700**
Subordinated liabilities	**–**	**30**	**433**	**558**	**9,256**	**10,277**
Total non-derivative financial liabilities	**151,787**	**2,806**	**6,571**	**27,299**	**10,292**	**198,755**
Derivative financial liabilities:						
Gross settled derivatives – outflows	**477**	**81**	**750**	**614**	**2,059**	**3,981**
Gross settled derivatives – inflows	**(390)**	**(21)**	**(751)**	**(619)**	**(2,256)**	**(4,037)**
Gross settled derivatives – net flows	**87**	**60**	**(1)**	**(5)**	**(197)**	**(56)**
Net settled derivative liabilities	**700**	**4**	**10**	**51**	**73**	**838**
Total derivative financial liabilities	**787**	**64**	**9**	**46**	**(124)**	**782**
At 31 December 2019						
Liabilities						
Deposits from banks	166	–	105	16,318	–	16,589
Customer deposits	135,377	1,820	7,134	7,898	13	152,242
Debt securities in issue	267	1,371	395	3,401	662	6,096
Other liabilities	1	25	77	344	421	868
Subordinated liabilities	67	63	101	1,342	9,853	11,426
Total non-derivative financial liabilities	135,878	3,279	7,812	29,303	10,949	187,221
Derivative financial liabilities:						
Gross settled derivatives – outflow	862	147	588	1,772	1,754	5,123
Gross settled derivatives – inflow	(36)	(113)	(585)	(1,800)	(1,918)	(4,452)
Gross settled derivatives – netflow	826	34	3	(28)	(164)	671
Net settled derivative liabilities	4,030	5	15	55	90	4,195
Total derivative financial liabilities	4,856	39	18	27	(74)	4,866

42 Financial risk management (continued)

The following tables set out the amounts and residual maturities of the Group's off balance sheet contingent liabilities, commitments and guarantees.

The Group	**Within 1 year £m**	**1-3 years £m**	**3-5 years £m**	**Over 5 years £m**	**Total £m**
31 December 2020					
Acceptances and endorsements	**–**	**–**	**–**	**–**	**–**
Other contingent liabilities	**94**	**9**	**–**	**104**	**207**
Total contingent liabilities	**94**	**9**	**–**	**104**	**207**
Lending commitments and guarantees	**44,030**	**2,146**	**453**	**914**	**47,543**
Other commitments	**1**	**16**	**–**	**12**	**29**
Total commitments and guarantees	**44,031**	**2,162**	**453**	**926**	**47,572**
Total contingents, commitments and guarantees	**44,125**	**2,171**	**453**	**1,030**	**47,779**

	Within 1 year £m	1-3 years £m	3-5 years £m	Over 5 years £m	Total £m
31 December 2019					
Acceptances and endorsements	1	–	–	–	1
Other contingent liabilities	97	17	1	104	219
Total contingent liabilities	98	17	1	104	220
Lending commitments and guarantees	35,488	945	646	819	37,898
Other commitments	–	–	–	14	14
Total commitments and guarantees	35,488	945	646	833	37,912
Total contingents, commitments and guarantees	35,586	962	647	937	38,132

The Bank	**Within 1 year £m**	**1-3 years £m**	**3-5 years £m**	**Over 5 years £m**	**Total £m**
31 December 2020					
Acceptances and endorsements	**–**	**–**	**–**	**–**	**–**
Other contingent liabilities	**94**	**9**	**–**	**104**	**207**
Total contingent liabilities	**94**	**9**	**–**	**104**	**207**
Lending commitments and guarantees	**43,866**	**2,146**	**453**	**914**	**47,379**
Other commitments	**1**	**16**	**–**	**12**	**29**
Total commitments and guarantees	**43,867**	**2,162**	**453**	**926**	**47,408**
Total contingents, commitments and guarantees	**43,961**	**2,171**	**453**	**1,030**	**47,615**

	Within 1 year £m	1-3 years £m	3-5 years £m	Over 5 years £m	Total £m
31 December 2019					
Acceptances and endorsements	1	–	–	–	1
Other contingent liabilities	97	17	1	104	219
Total contingent liabilities	98	17	1	104	220
Lending commitments and guarantees	35,319	945	646	819	37,729
Other commitments	–	–	–	14	14
Total commitments and guarantees	35,319	945	646	833	37,743
Total contingents, commitments and guarantees	35,417	962	647	937	37,963

43 Capital

Capital management

Capital is actively managed on an ongoing basis, covering the Bank and its regulated subsidiaries. Regulatory capital ratios are a key factor in budgeting and planning processes with updates on forecast ratios reviewed by the Lloyds Banking Group and Ring-Fenced Banks Asset and Liability Committees. Target capital levels take account of regulatory requirements, capacity for growth and to cover uncertainties. Capital policies and procedures are subject to independent oversight.

The Bank measures both its capital requirements and the amount of capital resources it holds to meet those requirements through applying the regulatory framework defined by the Capital Requirements Directive and Regulation (CRD IV), as amended by revisions to the Capital Requirements Directive implemented in December 2020 (CRD V) and by those provisions of the revised Capital Requirements Regulation (CRR II) that came into force in June 2019 and December 2020. The requirements are implemented in the UK by the Prudential Regulation Authority (PRA) and supplemented through additional regulation under the PRA Rulebook.

The UK left the EU on 31 January 2020 but remained subject to changes to EU capital regulation until the end of the transition period on 31 December 2020. Under temporary transitional powers (TTP) granted to the PRA, EU capital rules that existed on 31 December 2020 will continue to generally apply until 31 March 2022. This is subject to revision following any significant changes introduced by UK regulators, including changes which implement the remaining parts of CRR II that are not yet in force.

The minimum amount of total capital, under Pillar 1 of the regulatory framework, is set at 8 per cent of total risk-weighted assets. At least 4.5 per cent of risk-weighted assets are required to be covered by common equity tier 1 (CET1) capital and at least 6 per cent of risk-weighted assets are required to be covered by tier 1 capital. These minimum Pillar 1 requirements are supplemented by additional minimum requirements under Pillar 2A of the regulatory framework, the aggregate of which is referred to as the Total Capital Requirement (TCR).

Under Pillar 2A, additional requirements are set through the issuance of a bank specific Individual Capital Requirement (ICR), which adjusts the Pillar 1 minimum requirement for those risks not covered or not fully covered under Pillar 1. A key input into the PRA's ICR process is a bank's own assessment of the amount of capital it needs, a process known as the Internal Capital Adequacy Assessment Process (ICAAP).

A range of additional bank specific regulatory capital buffers apply under CRD IV, which are required to be met with CET1 capital. These include a capital conservation buffer (2.5 per cent of risk-weighted assets) and a time-varying countercyclical capital buffer (currently around 0 per cent of risk-weighted assets).

The Bank applies the full extent of the IFRS 9 transitional arrangements for capital as set out under CRR Article 473a (as amended via the CRR 'Quick Fix' revisions published in June 2020). Specifically, the Bank has opted to apply both paragraphs 2 and 4 of CRR Article 473a (static and dynamic relief) and in addition to apply a 100 per cent risk weight to the consequential Standardised credit risk exposure add-back as permitted under paragraph 7a of the revisions. As at 31 December 2020, static relief (including 'locked' dynamic relief recognised prior to 1 January 2020) under the transitional arrangements amounted to £204 million (31 December 2019: £248 million) and dynamic relief (from 1 January 2020) under the transitional arrangements amounted to £606 million, through CET1 capital.

During the year, the Bank and its regulated subsidiaries complied with all of the externally imposed capital requirements to which they are subject.

Regulatory capital development

The regulatory framework within which the Bank operates continues to be developed at a global level through the Financial Stability Board (FSB) and Basel Committee on Banking Supervision (BCBS) and within the UK by the PRA and through directions from the Financial Policy Committee (FPC). The Bank continues to monitor these developments very closely, analysing potential capital impacts to ensure that, through organic capital generation and management actions, the Bank and its regulated subsidiaries continue to maintain a strong capital position that exceeds both minimum regulatory requirements and the Bank's risk appetite and is consistent with market expectations.

Capital resources

Regulatory capital is divided into tiers depending on the degree of permanency and loss absorbency exhibited.

- Common equity tier 1 (CET1) capital represents the strongest form of capital consisting of shareholders' equity after a number of regulatory adjustments and deductions are applied. These include adjustments for IFRS 9 transitional arrangements, the accrual for foreseeable dividends (where applicable), the elimination of the cash flow hedging reserve and deductions for goodwill, other intangible assets, prudent valuation, defined benefit pension surplus and deferred tax assets.
- Fully qualifying additional tier 1 (AT1) capital comprises non-cumulative perpetual securities containing specific provisions to write down the security should the CET1 ratio fall to a defined trigger limit. Under transitional rules for capital, securities that do not qualify in their own right as AT1 capital, but were issued and recognised as eligible tier 1 capital prior to the implementation of CRD IV, can be partially included within AT1 capital ('grandfathering'), until they are phased out altogether by 2022. To the extent these securities no longer qualify as AT1 capital they may nevertheless still qualify as tier 2 capital either under transitional rules for tier 2 securities or on an end point basis.
- Tier 2 (T2) capital largely comprises certain other subordinated debt securities that do not qualify as AT1. They must have an original term of at least 5 years, cannot normally be redeemed within their first 5 years and are phased out as T2 regulatory capital in the final 5 years before maturity. Under transitional rules for capital, securities that do not qualify in their own right as T2 capital, but were issued and recognised as eligible T2 capital prior to the implementation of CRD IV, can be partially included within T2 capital ('grandfathering'), until they are phased out altogether by 2022. Eligible provisions, reflecting the excess of IFRS 9 expected credit losses over corresponding regulatory expected losses, are added back to T2 capital, net of the application of IFRS 9 transitional adjustments.

The Bank's transitional capital resources are summarised as follows:

	2020 £m	2019 £m
Common equity tier 1 capital	**9,510**	8,307
Additional tier 1 capital	**2,221**	2,872
Tier 2 capital	**1,846**	2,340
Total capital	**13,577**	13,519

44 Cash flow statements

a Change in operating assets

	The Group		The Bank	
	2020 £m	2019 £m	**2020 £m**	2019 £m
Change in financial assets held at amortised cost	**(6,658)**	3,660	**(8,020)**	3,566
Change in amounts due from Group undertakings	**68,546**	(38,602)	**70,209**	(39,020)
Change in derivative financial instruments and financial assets at fair value through profit or loss	**2,890**	(955)	**2,824**	(1,104)
Change in other operating assets	**90**	177	**113**	183
Change in operating assets	**64,868**	(35,720)	**65,126**	(36,375)

b Change in operating liabilities

	The Group		The Bank	
	2020 £m	2019 £m	**2020 £m**	2019 £m
Change in deposits from banks	**(1,777)**	(4,436)	**(1,778)**	(4,436)
Change in customer deposits	**11,154**	(10,291)	**11,182**	(10,317)
Change in amount due to Group undertakings	**(69,665)**	49,849	**(70,201)**	50,213
Change in debt securities in issue	**(2,907)**	(657)	**(2,688)**	(484)
Change in derivative financial instruments and financial liabilities at fair value through profit or loss	**(2,682)**	1,088	**(2,688)**	1,134
Change in other operating liabilities[1]	**(273)**	(70)	**(290)**	59
Change in operating liabilities	**(66,150)**	35,483	**(66,463)**	36,169

1 Includes £1 million (2019: £9 million) for the Group and £1 million (2019: £9 million) for the Bank in respect of lease liabilities.

c Non-cash and other items

	The Group		The Bank	
	2020 £m	2019 £m	**2020 £m**	2019 £m
Depreciation and amortisation	**232**	235	**233**	235
Dividends received from subsidiaries	**–**	–	**(45)**	(83)
Revaluation of investment properties	**20**	8	**–**	–
Impairment charge relating to undrawn balances	**74**	5	**74**	5
Allowance for loan losses	**1,548**	445	**1,530**	595
Write-off of allowance for loan losses, net of recoveries	**(454)**	(508)	**(445)**	(496)
Impairment losses on investments in subsidiaries	**–**	–	**–**	9
Payment protection insurance provision and other regulatory provisions	**107**	1,217	**106**	1,218
Other provision movements	**68**	(19)	**67**	(19)
Unwind of discount on impairment allowances	**(9)**	(11)	**(12)**	(15)
Foreign exchange element on balance sheet[1]	**6**	494	**59**	264
Interest expense on subordinated liabilities	**146**	186	**146**	185
Other non-cash items	**10**	(16)	**10**	(25)
Total non-cash items	**1,748**	2,036	**1,723**	1,873
Payments in respect of other provisions	**(230)**	(464)	**(225)**	(455)
Payments in respect of payment protection insurance provision	**(475)**	(759)	**(471)**	(757)
Other	**9**	(10)	**9**	(10)
Total other items	**(696)**	(1,233)	**(687)**	(1,222)
Non-cash and other items	**1,052**	803	**1,036**	651

1 When considering the movement on each line of the balance sheet, the impact of foreign exchange rate movements is removed in order to show the underlying cash impact.

44 Cash flow statements (continued)

d Analysis of cash and cash equivalents as shown in the balance sheet

	The Group		The Bank	
	2020 £m	2019 £m	**2020 £m**	2019 £m
Cash and balances at central banks	**2,841**	2,492	**2,841**	2,492
Less: mandatory reserve deposits[1]	**(2,143)**	(1,775)	**(2,143)**	(1,775)
	698	717	**698**	717
Loans and advances to banks	**207**	311	**205**	307
Less: amounts with a maturity of three months or more and amounts due from fellow Lloyds Banking Group undertakings	**(56)**	(269)	**(56)**	(269)
	151	42	**149**	38
Total cash and cash equivalents	**849**	759	**847**	755

1 Mandatory reserve deposits are held with local central banks in accordance with statutory requirements; these deposits are not available to finance the Group's day-to-day operations.

45 Future accounting developments

The following pronouncements are not applicable for the year ending 31 December 2020 and have not been applied in preparing these financial statements.

With the exception of certain minor amendments, as at 11 March 2021 these pronouncements have been endorsed for use in the United Kingdom.

Interest Rate Benchmark Reform
The IASB's Phase 2 amendments in response to issues arising from the replacement of interest rate benchmarks in a number of jurisdictions are effective for annual periods beginning on or after 1 January 2021.

Under these amendments, an immediate gain or loss is not recognised in the income statement where the contractual cash flows of a financial asset or financial liability are amended as a direct consequence of the rate reform and the revised contractual terms are economically equivalent to the previous terms. In addition, hedge accounting is continued for relationships that are directly affected by the reform.

These amendments are not expected to have a significant impact on the Group.

Minor amendments to other accounting standards
The IASB has issued a number of minor amendments to IFRSs effective 1 January 2021 and in later years (including IFRS 9 *Financial Instruments* and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*). These amendments are not expected to have a significant impact on the Group.

46 Other information

Bank of Scotland plc and its subsidiaries form a leading UK-based financial services group, whose businesses provide a wide range of banking and financial services in the UK and in certain locations overseas.

Bank of Scotland plc's immediate parent undertaking is HBOS plc and its ultimate parent undertaking and controlling party is Lloyds Banking Group plc which is incorporated in Scotland. Copies of the consolidated annual report and accounts of Lloyds Banking Group plc may be obtained from Lloyds Banking Group's head office at 25 Gresham Street, London EC2V 7HN or downloaded via www.lloydsbankinggroup.com.

Subsidiaries and related undertakings

In compliance with Section 409 of the Companies Act 2006, the following comprises a list of all related undertakings of the Group, as at 31 December 2020. The list includes each undertaking's registered office and the percentage of the class(es) of shares held by the Group. All shares held are ordinary shares unless indicated otherwise in the notes.

Subsidiary Undertakings

The Group directly or indirectly holds 100 per cent of the share class or a majority of voting rights (including where the undertaking does not have share capital as indicated) in the following undertakings. All material subsidiary undertakings are consolidated by Lloyds Banking Group

Name of undertaking	Notes
Anglo Scottish Utilities Partnership 1	+ *
Automobile Association Personal Finance Ltd	4 i
Bank of Scotland (B G S) Nominees Ltd	5 *
Bank of Scotland (Stanlife) London Nominees Ltd – applied for strike off	5 *
Bank of Scotland Edinburgh Nominees Ltd	5 *
Bank of Scotland Equipment Finance Ltd (in liquidation)	11 i
Bank of Scotland London Nominees Ltd – applied for strike off	5 *
Bank of Scotland Nominees (Unit Trusts) Ltd – applied for strike off	5 *
Bank of Scotland P.E.P. Nominees Ltd – applied for strike off	5 *
Bank of Scotland Structured Asset Finance Ltd	1 i
Bank of Scotland Transport Finance 1 Ltd (in liquidation)	11 i
Bank of Wales Ltd	7 i
Barents Leasing Ltd	1 i
Birmingham Midshires Financial Services Ltd	4 i
Birmingham Midshires Land Development Ltd (in liquidation)	11 i
Birmingham Midshires Mortgage Services Ltd (in liquidation)	11 i
BOS (Ireland) Property Services 2 Ltd	12 i
BOS (Shared Appreciation Mortgages (Scotland) No. 2) Ltd	4 i
BOS (Shared Appreciation Mortgages (Scotland) No. 3) Ltd	4 i
BOS (Shared Appreciation Mortgages (Scotland)) Ltd	4 i
BOS (Shared Appreciation Mortgages) No. 1 plc	4 # i
BOS (Shared Appreciation Mortgages) No. 2 plc	4 # i
BOS (Shared Appreciation Mortgages) No. 3 plc	4 # i
BOS (Shared Appreciation Mortgages) No. 4 plc	4 # i
BOS (Shared Appreciation Mortgages) No. 5 plc	4 i
BOS (Shared Appreciation Mortgages) No. 6 plc	4 i
BOSSAF Rail Ltd	1 i
BOS Personal Lending Ltd	4 ii iii
British Linen Leasing (London) Ltd	5 i
British Linen Leasing Ltd	5 i
British Linen Shipping Ltd	5 i
Capital 1945 Ltd	7 i
Capital Bank Leasing 3 Ltd (in liquidation)	11 i
Capital Bank Leasing 5 Ltd	7 i
Capital Bank Leasing 12 Ltd	5 i
Capital Bank Property Investments (3) Ltd	7 i
Capital Personal Finance Ltd	4 i
CBRail S.A.R.L.	6 i
CF1 Ltd (in liquidation)	11 iv vi #
CF Asset Finance Ltd (in liquidation)	11 i
First Retail Finance (Chester) Ltd	4 i
Forthright Finance Ltd	7 i
Halifax Credit Card Ltd (in liquidation)	11 ii iii iv
Halifax Leasing (March No.2) Ltd	1 i
Halifax Leasing (September) Ltd	1 i
Halifax Loans Ltd	4 i
Halifax Mortgage Services Ltd	4 i
Halifax Vehicle Leasing (1998) Ltd	4 i
HBOS Covered Bonds LLP	4 *
HBOS Social Housing Covered Bonds LLP	7 *
Home Shopping Personal Finance Ltd	4 i
IBOS Finance Ltd	7 i
Intelligent Finance Financial Services Ltd	4 i
Intelligent Finance Software Ltd	4 i
Lex Vehicle Leasing (Holdings) Ltd (in liquidation)	11 ii iii v
Lex Vehicle Leasing Ltd (in liquidation)	11 i
Lloyds Bank (Fountainbridge 1) Ltd (in liquidation)	2 i
Lloyds Bank (Fountainbridge 2) Ltd (in liquidation)	2 i
Lloyds Capital GP Ltd	10 i
Lloyds Hypotheken B.V.	13 i
Lloyds Secretaries Ltd	1 i
London Uberior (L.A.S. Group) Nominees Ltd – applied for strike off	5 *
Membership Services Finance Ltd	4 i
NFU Mutual Finance Ltd	7 ii iv #
Nordic Leasing Ltd (in liquidation)	11 i
NWS Trust Ltd	5 i
Pacific Leasing Ltd	1 i
Seabreeze Leasing Ltd	1 i
Seaspirit Leasing Ltd	1 i
Standard Property Investment (1987) Ltd	5 ii iii
Standard Property Investment Ltd	14 i #
Sussex County Homes Ltd	4 i
The British Linen Company Ltd	5 i
The Mortgage Business plc	4 i
Thistle Leasing	+ *
Tower Hill Property Investments (7) Ltd	7 i #
Tower Hill Property Investments (10) Ltd	7 i #
Tranquility Leasing Ltd	1 i
Uberior Nominees Ltd – applied for strike off	5 *
Uberior Trustees Ltd – applied for strike off	5 *

Subsidiary Undertakings (continued)
The Group has determined that it has the power to exercise control over the following entities without having the majority of the voting rights of the undertakings. Unless otherwise stated, the undertakings do not have share capital or the Group does not hold any shares.

Name of undertaking	Notes
Addison Social Housing Holdings Ltd	3
Deva Financing Holdings Ltd	9
Deva Financing plc	9
Edgbaston RMBS 2010-1 plc	9
Edgbaston RMBS Holdings Ltd	9
Elland RMBS 2018 plc	9
Elland RMBS Holdings Ltd	9
Housing Association Risk Transfer 2019 DAC	8
Molineux RMBS 2016-1 plc	9
Molineux RMBS Holdings Ltd	9
Penarth Asset Securitisation Holdings Ltd	9
Penarth Funding 1 Ltd	9
Penarth Funding 2 Ltd	9
Penarth Master Issuer plc	9
Penarth Receivables Trustee Ltd	9
Permanent Funding (No. 1) Ltd	9
Permanent Funding (No. 2) Ltd	9
Permanent Holdings Ltd	9
Permanent Master Issuer plc	9
Permanent Mortgages Trustee Ltd	9
Permanent PECOH Holdings Ltd	9
Permanent PECOH Ltd	9
Swan Funding 2 Ltd	3
Syon Securities 2019 DAC	8
Syon Securities 2020 DAC	8
Syon Securities 2020-2 DAC	8

Associated Undertakings
The Group has a participating interest in the following undertakings.

Name of undertaking	% of share class held by immediate parent company (or by the Group where this varies)	Registered office address (UK unless stated otherwise)	Notes
Addison Social Housing Ltd	20%	1 Bartholomew Lane, London, EC2N 2AX	i
Connery Ltd	20%	44 Esplanade, St. Helier, Jersey JE4 9WG	&

* The undertaking does not have share capital
+ The undertaking does not have a registered office
# In relation to Subsidiary Undertakings, an undertaking external to the Group holds shares
& The Group holds voting rights of between 20% and 49.9%
(i) Ordinary Shares
(ii) A Ordinary Shares
(iii) B Ordinary Shares
(iv) C Ordinary Shares
(v) Redeemable Preference Shares
(vi) N Ordinary Shares

Registered office addresses
(1) 25 Gresham Street, London, EC2V 7HN
(2) Atria One, 144 Morrison Street, Edinburgh, EH3 8EX
(3) 44 Esplanade, St. Helier, Jersey, JE4 9WG
(4) Trinity Road, Halifax, West Yorkshire HX1 2RG
(5) The Mound, Edinburgh, EH1 1YZ
(6) 1A Heienhaff, Senningerberg, L-1736, Luxembourg
(7) Cawley House, Chester Business Park, Chester, CH4 9FB
(8) 5th Floor, The Exchange, George's Dock, IFSC, Dublin 1, Ireland
(9) 1 Bartholomew Lane, London EC2N 2AX
(10) 6th Floor, 125 London Wall, London EC2Y 5AS
(11) 1 More London Place, London, SE1 2AF
(12) Suite 6, Rineanna House, Shannon Free Zone, Co. Clare, Ireland
(13) Fascinatio Boulevard 1302, 2909VA Capelle aan den Ijssel, Netherlands
(14) Caledonian Exchange, 19A Canning Street, Edinburgh, EH3 8HE

RFI_122513

Printed by CPI Colour